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THE STATE OF SMALL BUSINESS: A REPORT OF THE PRESIDENT

HEARING

BEFORE THE

COMMITTEE ON SMALL BUSINESS
UNITED STATES SENATE

NINETY-SEVENTH CONGRESS

SECOND SESSION

ON

THE STATE OF SMALL BUSINESS: A REPORT OF THE PRESIDENT

MARCH 31, 1982

Printed for the use of the Committee on Small Business

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THE STATE OF SMALL BUSINESS: A REPORT OF THE PRESIDENT

WEDNESDAY, March 31, 1982

U.S. SENATE,
COMMITTEE ON SMALL BUSINESS,
Washington, D.C.

The committee met, pursuant to notice, at 10:10 a.m., in room 424, Russell Senate Office Building, Hon. Lowell Weicker, Jr., chairman of the committee, presiding.

Present: Senators Weicker, D'Amato, and Nunn.

Also present: Brian F. Hartman, financial analyst; Alan L. Chvotkin, chief minority counsel; Bruce Ray, Office of Senator D'Amato; and Dorothy C. Olson, hearing clerk.

STATEMENT OF HON. LOWELL WEICKER, JR., A U.S. SENATOR FROM THE STATE OF CONNECTICUT, AND CHAIRMAN, SENATE COMMITTEE ON SMALL BUSINESS

Senator WEICKER. Today the Committee on Small Business will hold a hearing on the first Presidential Report on the State of Small Business, and Small Business and Competition. It is a pleasure for the committee to have the Chairman of the President's Council of Economic Advisers, Murray Weidenbaum, here to discuss the state of the small business economy.

Congress mandated this report in 1980 as a way of forcing the executive branch to focus its attention on the small business community and its needs, specifically. Certainly, the President has always focused on the overall economic picture and reported on it in an annual state of the economy address. But in painting the broad picture, in macroeconomics and long-term views, somehow the smaller, small-business picture always seems to get lost.

Here, in a few short statements, is how the small business picture looks today. New home sales, released earlier this week, dropped to their second lowest level on record. U.S. car sales dropped 44 percent for the 10 days ending March 20, from the same period 1 year earlier. All automakers are now offering rebates of $350 to $2,000, but it is not helping. Initial claims for State unemployment benefit rose 4.26 percent in the week ending March 13 over the previous week. And the latest Dun & Bradstreet figures show that for the first 8 months of 1982, businesses went belly-up at a rate 55.3 percent higher than the rate recorded 1 year ago.

On paper, statistics like these are known as "unfavorable economic indicators." In the real world, every one of them marks a living, breathing human tragedy.

The problems that small businesses are facing right now raise some very serious questions, questions about the future of small business and the future of the economy. These questions need to be addressed, and in my view, they need to be addressed by those at the top, those who make policy in this land.

It is my hope that this annual report will answer some of these questions, and I now look forward to hearing the testimony of our first witness.

STATEMENT OF HON. MURRAY L. WEIDENBAUM, CHAIRMAN, COUNCIL OF ECONOMIC ADVISERS, ACCOMPANIED BY DR. JAMES BURNHAM, STAFF DIRECTOR AND SPECIAL ASSISTANT TO THE CHAIRMAN; AND DR. ALLEN PARKMAN, SENIOR ECONOMIST, COUNCIL OF ECONOMIC ADVISERS

Dr. WEIDENBAUM. Thank you, Mr. Chairman. I appreciate this opportunity to appear before your committee to discuss the state of small business in 1982, and I would like to read the highlights of my statement, if I may.

As you know, the President recently submitted to Congress for the first time a report on the state of small business. In my statement today, I would like to focus on some of the key points discussed in the President's report.

I am accompanied today by Dr. James Burnham, Staff Director and Special Assistant to the Chairman, Council of Economic Advisers, and Dr. Allen Parkman, Senior Economist on the staff of the Council of Economic Advisers.

By the very nature of their structure, resources, and the activities within which they participate, small firms are highly susceptible to the ups and downs of overall economic activity. Therefore, small business has been very concerned about this downturn in economic activity that we have experienced over the past year. All of us share those concerns. I personally continue to be optimistic about our prospects for economic recovery in the late spring or early summer. We recognize that at the moment there is a very limited amount of favorable economic news.

We are in a very serious recession; I do not think there is any question about it. In terms of a strong wind, a new composite index of the National Association of Purchasing Management, which led by 2 months the upturns in 1975 and 1980, that index turned up in December and rose again in January and February. Yet, the Commerce Department's leading indicators continue declining, although at a slowing rate. On the other hand, all indicators of price trends suggest continued improvement in the months ahead. In addition, interest rates may have resumed a downward trend, but as we know they never move in a straight line for any length of time, and the present is a good example of that.

I would like to turn to some of the key issues affecting small businesses. The first is inflation. For the men and women who own small businesses, inflation is a very serious problem. It earns this distinction essentially because it exacerbates the other serious problems of small business, such as the need for capital, the cost and availability of investment funds, and the uncertainty concerning the behavior of the economy and the posture economic policies.

The economic program of this administration will establish a solid and lasting economic framework for providing small business with relief from inflation in many ways. First, adherence to policy of stable and limited monetary growth eliminates the primary cause of inflation. Second, improved incentives and reduced labor costs flowing from the reduction in personal income taxes can result in improved labor productivity. Finally, help in controlling other costs of doing business will be derived from the elimination of unnecessary and inefficient regulation. Taken together, our policy should reduce the extent of the inflation problem facing small business.

Interest rates are another very serious problem for small businesses, as they are for many other sectors of the economy. High interest rates cause severe cash flow problems, which are particularly threatening to small businesses which tend to be undercapitalized. The heightened sensitivity of small businesses to high and volatile interest rates stems from that tendency and often from their need for new capital to finance growth. Moreover, the deductibility of interest is of less help to small business since they frequently generate insufficient income to take full advantage of the tax deduction.

The key to lower and steadier interest rates is a consistently lower rate of inflation. When inflation is high, interest rates are pushed up. In addition, the economic instability suggested by the presence of high interest rates leads to a larger risk premium as well. Lower interest rates is a key need of this economy and a top priority of this administration.

There are many impediments reducing access to adequate amounts of capital, and unfortunately some of these work to the particular detriment of small business. Saving in recent years has been depressed by the combination of inflation and high marginal tax rates. Small business has suffered not only from the general lack of savings, but also because entrepreneurs have historically looked to the savings of family and friends to supply equity.

Unfortunately, depressed savings rates and limited access are not the only problems. The past tendency of the Federal Government to rapidly expand its claims on resources has reduced savings available to firms both through taxation and Government borrowing to finance Government deficits. Unfortunately, this serious problem very much continues. The most fundamental policy to improve small business access to capital is the reduction of the Government's claims on resources. Thus, spending restraint is the key element, since high taxes as well as high borrowing reduce the resources available to the private sector for investment and growth.

To be blunt, the current deficit is much higher than I would like it to be. But, given the recession, I believe the sensible approach is to plan carefully for reducing that deficit in the years ahead. In my judgment, the central issue we should be concerned with is the overall claim of the Government on society's resources. We must continue to work for a reduction in unnecessary and wasteful Government spending.

On a positive note, I would like to point out that the Economic Recovery Tax Act provides strong incentives for increased savings

by raising the after-tax return to saving, as well as by opening new avenues for savings such as the IRA provisions.

The Economic Recovery Tax Act [ERTA] also seeks to provide incentives for firms to increase their capital outlays, as well as to encourage employment growth. There has been some confusion among small businesses about the incentives that ERTA creates for small businesses. Since small businesses tend to be labor intensive, there has been a feeling that the provisions were biased toward capital intensive and hence, inadvertently, toward larger industries.

It is important to note that since most small firms are labor intensive, their cost structure should benefit as the impact of tax reductions help restrain increases in labor costs. The reduction in personal income tax rates has the effect of increasing the take-home pay of workers for any given wage level. Also, so many small businesses are unincorporated, and they will be taxed under the lower personal income tax rates.

The Accelerated Cost Recovery System [ACRS] will benefit small businesses and in a fundamental way. Simplification of depreciation is the key here to increased benefits for small businesses. Within ERTA there is an extensive list of special provisions targeted to small business, including lower tax rates on the two lowest corporate income tax brackets, the simplification of LIFO inventory accounting, the increased allowance for accumulated earnings, and also family owned businesses will benefit from the reductions in the estate tax.

Small businesses found themselves at a competitive disadvantage because of the economies of scale and complying with Government regulations. In my own studies, I consistently found that the burden of regulation is proportionately much greater for small firms than for large firms, simply because compliance costs are spread out over smaller quantities of production. One of the major programs of this administration is regulatory relief. The Presidential Task Force on Regulatory Relief has identified many existing regulations which are considered by small businesses to be particularly onerous, and we are subjecting those regulations to indepth review.

These include a comprehensive reassessment of ERISA, of the driver's log and daily special maintenance report required of trucking companies, and meat and poultry inspection exemptions. That is only the beginning of what must be a continuing effort.

In addition to the regulations themselves, small businesses have been hurt by the paperwork requirement, and OMB has made a dramatic start in cutting down this paperwork burden. Last year, they disapproved 1 of every 12 requests for paperwork to be imposed on small businesses.

The President's Report on Small Business also contains many specific actions being taken to assist small business in these difficult times. To cite a few, the President is directing the Commissioner of the IRS to include small business representatives in the advisory groups reviewing the tax laws.

The President is directing each Federal agency to accelerate the time for completion of the review of existing regulations, as specified in the Regulatory Flexibility Act, reducing that time from 10

to 5 years. He has also requested the Attorney General to examine the antitrust laws to be sure that they do not interfere with the ability of patent and copyright holders, including those in the small business sector, to reap the proper rewards for their innovations.

The administration is taking action to insure that payments are made promptly to Federal contractors. The Commerce Department has been directed to work with the SBA to emphasize programs that encourage exports by small businesses.

This administration has increased the program levels for SBA's minority small business program and the Commerce Department's Minority Business Development Agency.

Since data availability is important, the President has asked the Congress to enact his budget proposal for SBA's small business data base.

In conclusion, I would like to end on a positive note. Although all segments of the economy are going through very difficult times, and there is no question about that in my mind, this administration is attempting to put in place a program which will create a positive, long term environment in which small businesses can be formed and grow and prosper. Thank you very much.

[The prepared statement of Mr. Weidenbaum follows:]

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March 31, 1982

SMALL BUSINESS IN 1982

Statement of
of
Murray L. Weidenbaum
Chairman
Council of Economic Advisers

Before the

Senate Small Business Committee

March 31, 1982

Mr. Chairman and Members of the Committee:

I appreciate this opportunity to appear before your Committee to discuss the state of small business in 1982.

As you know, the President recently submitted to Congress the first report on The State of Small Business as required by P.L. 96-302. Included with the President's report was the Small Business Administration's Annual Report on Small Business and Competition. The SBA report set out the most recent and relevant evidence describing small businesses, including how many there are, where they are, and who owns them. It describes changes in the economy and the small business sector, and details the impact of Federal policy on small business. This is the first of a new series of documents which will be an important source of information for those people interested in the condition and prospects for small business.

In my statement today, I would like to focus on some of the important points that are discussed in the President's report on small business.

By the very nature of their structure, resources, and the types of activities in which they participate, small firms are highly susceptible to the ups and downs of overall economic activity. Therefore, small business has been very concerned about the slowdown in economic activity that we have experienced over the past year. We all share their concerns. However, I continue to be optimistic about our prospects for economic recovery in the late spring and

early summer. We recognize that at the moment there is a limited amount of favorable economic news. The new composite diffusion index of the National Association of Purchasing Management -- which presaged by two months the upturns in 1975 and 1980 -- turned up in December and rose in January and February. Yet, the Department of Commerce's leading indicators have continued declining.

On the other hand, all indicators of price trends suggest continued improvement in the months ahead. In addition, interest rates may have resumed a downward trend. With this as a background let me turn to some of the issues that are of particular interest to small business.

Inflation

For the men and women who own small businesses, inflation is a particularly serious problem. It earns this distinction essentially because it exacerbates the other problems of small business, such as the need for capital, the cost and availability of investment funds, and the uncertainty concerning the behavior of the economy and the posture of economic policies.

The economic program of this Administration will establish a solid, lasting economic framework for providing small business with relief from inflation in several ways. First, adherence to a policy of stable and limited monetary growth eliminates the primary cause of inflation in our economy. Second, the improved incentives and reduced labor costs flowing from the reduction in Federal personal income

tax rates should result in improved labor productivity, a matter of great importance to small businesses given their tendency to be labor intensive. Finally, help in controlling other costs of doing business will be derived from the elimination of unnecessary and inefficient regulatory burdens. Taken together, therefore, our policies should reduce the extent of the inflation problem facing small business.

Interest Rates

Interest rates are a serious problem for small businesses as they are for many other sectors of the economy. High interest rates can cause severe cash flow problems which are particularly threatening to small businesses. The heightened sensitivity of small business to high and volatile interest rates stems from the tendency of these businesses to be undercapitalized and/or to be facing substantial capital needs to finance growth. Moreover, the deductability of interest expenses is of less help to small businesses since they frequently generate insufficient income (particularly new ones just starting up operations) to take full advantage of the tax deduction.

The key to lower and steadier interest rates is a consistently lower rate of inflation. When the inflation rate is high, interest rates are pushed up by the need of lenders for an inflation premium to protect the real value of the loaned funds. In addition, the economic instability

suggested by the presence of high interest rates leads to a larger risk premium as well. Lower interest rates is a top priority of this Administration.

Access to Capital

There are many impediments reducing access to adequate amounts of capital for firms and, unfortunately, some of these work to the particular detriment of small business. Saving in recent years has been depressed by the interaction of inflation and high marginal tax rates. Inflation, as we all know, pushes taxpayers into higher income brackets (which are subject to progressively higher rates of taxation). Small business has suffered not only from the general lack of savings, but also because entrepreneurs have historically looked to the savings of family and friends to supply the equity investment funds used as seed capital to form new businesses.

Unfortunately, depressed saving rates and limited access are not the only problems. The past tendency of the Federal government to rapidly expand its claims on resources has reduced savings available to firms both through taxation and government borrowing to finance government deficits. The most fundamental policy to improve small business access to capital is the reduction of the government claims on resources. Thus, spending restraint is the key element, since high taxes as well as borrowing reduce the resources available to the private sector for investment and growth.

To be blunt, the current deficit is much higher than I would like it to be, but, given the recession, I believe the sensible approach is to plan carefully for reducing the deficit in the years that follow. Bear in mind the central issue that we should be concerned with is the overall claim of the government on society's resources rather than just the part of those claims which has to be financed by government borrowing. We must continue to work for a reduction in unnecessary and wasteful government expenditures.

On a more positive note, I would like to point out that the Economic Recovery Tax Act provides strong incentives for increased savings by increasing the after tax return to saving as well as by opening new avenues for savings such as the new IRA provisions.

Tax Incentives

The Economic Recovery Tax Act also seeks to provide incentives for firms to increase their capital outlays as well as to encourage employment growth. There has been a great deal of confusion among small businesses about the incentives that ERTA creates for small businesses. Since small businesses tend to be labor intensive, there has been a feeling that the provisions of ERTA were biased toward capital intensive, larger businesses.

It is important to note that since most small firms are labor intensive, their cost structure should benefit as the impact of the tax reductions help restrain increases in

labor costs. The reduction in personal income tax rates has the effect of increasing the take home pay of workers for any given wage level. Therefore, because of the higher take home pay, firms also should find more and better quality workers available at prevailing wage rates.

The Accelerated Cost Recovery System included in ERTA also will benefit small businesses. Within ERTA, there is an extensive list of special provisions aimed specifically to small business. They will benefit from the lower tax rates on the two lowest corporate income tax brackets, the simplification of LIFO inventory accounting, and the increased allowance for accumulated earnings, just to mention a few examples.

Regulation

Small business has found itself at a competitive disadvantage in the past because of the existence of efficiencies of scale in regulatory compliance. The burden of many regulations is proportionately much greater for small firms than for large firms because compliance costs are spread out over smaller quantities of production. One of the major programs of this Administration is regulatory relief for all businesses and individuals. The Presidential Task Force on Regulatory Relief has identified a number of existing regulations which are considered by small businesses to be particularly onerous and these regulations are being subjected to in-depth review.

The regulations being reviewed include a comprehensive reassessment of ERISA regulations, the driver's log and daily inspection and maintenance reports required of trucking companies, and meat and poultry inspection exemptions, among others. These are only the beginning of a continuing effort to modify and reduce inefficient and wasteful regulations.

On an on-going basis, the recently enacted Regulation Flexibility Act provides an important mechanism for causing agencies to focus on existing regulations that unnecessarily impede growth and development of small business. The full utilization of the provisions of the Regulatory Flexibility Act are a principal theme of this Administration.

In addition to the regulations themselves, Small Business has been hurt by the paperwork required to comply with numerous Federal regulations. The Office of Management and Budget has made a dramatic start in cutting down this paperwork burden. During 1981, OMB disapproved about one of every twelve requests for paperwork to be imposed on small business. In addition to addressing the broad concerns discussed above, the President's small business report also contains a number of specific actions that are being taken to assist small business in these difficult times. These actions include:

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1) The President is directing the Commissioner of Internal Revenue to include representatives of small business in advisory groups which review administration of the tax laws.

2) The President is directing each Federal Department and Agency to accelerate the time for completion of the review of existing regulations as specified in the Regulatory Flexibility Act from ten to five years. In addition, he is directing the Comptroller of the Currency and asking the Chairs of the Federal Home Loan Bank Board, the Federal Deposit Insurance Corporation, and the Federal Reserve Board to follow the Regulatory Flexibility Act guidelines for assessing the small business impact of their proposals for changing our financial institutions.

3) The President has also requested the Attorney General to examine antitrust laws to ensure that they do not interfere with the ability of patent and copyright holders, including those in the small business sector, to reap the proper rewards for their innovative contributions.

4) The Adminitration is taking action to ensure that payments are made promptly to Federal contractors.

5) The Department of Commerce has been directed to work with the SBA to emphasize programs that encourage exports by small businesses.

6) This Administration has increased the program levels for SBA's Minority Small Business program and the

Commerce Department's Minority Business Development Agency for fiscal year 1982 as compared to fiscal year 1981.

7) Since data availability is important for determining policies for small business, the President has asked the Congress to enact his budget proposal for SBA's small business data base.

In conclusion, I would like to end my prepared statement on a positive note. Although all segments of the U.S. economy are going through difficult times, this Administration has attempted to put in place a program which will create a positive long term environment in which small business can expand and prosper.

Senator WEICKER. Thank you very much. Let me start off by asking a question based on your own remarks, which remarks I would agree with, such as those that relate to spending restraint by Government or, more particulary, to use your words, to try and diminish "the claim of Government on society's resources."

Would you not agree that this claim encompasses all agencies of Government?

Dr. WEIDENBAUM. Yes, sir.

Senator WEICKER. And quite frankly, the main impetus for that claim right now emanates from the defense budget?

Dr. WEIDENBAUM. Yes, sir.

Senator WEICKER. So is it your advice to the President that if we are going to have the restraint of these claims of Government on society's resources, that it should include the Defense Department?

Dr. WEIDENBAUM. As the chairman knows, I am a "hawk" when it comes to slowing down the rapid growth of Government spending. I have stated that no agency should be exempt from that budget scrutiny.

Senator WEICKER. Point No. 2. What concerns me about this economic policy is that certain of the results are going to be irreversible, regardless of how long or strong the recovery. What I refer to specifically is the permament elimination of hundreds of small businesses and the resultant concentration of economic power in the hands of a few. That is not going to change with the recovery; these businesses are gone.

Yesterday, we had several groups in town: The veterans, The communications workers, and two other groups that relate to a point I am trying to make, the independent insurance agents and the realtors. And that is a good place to start, because what concerns me right now is that, due to these economic policies, I see real estate, insurance, financial services, banking, all coming under one roof.

What the problem is here, Mr. Weidenbaum, is that we might resolve some of the problems today, in terms of preserving some businesses, as ones that have capital or access to capital or are able to afford capital, can bring them under their umbrella. But once having achieved that consolidation, you literally are playing the ball game on your 1-yard line. The next time it hits the fan, if one of these fellows goes, then you really have a problem.

The fact is that for years, for decades ahead, competition will be lessened in the United States because of the diminishing small business activity and the elimination of small business. Of course, when that happens, in terms of the quality of the product and in terms of the price of the product, it is far less a consumer's market.

The main point I am trying to make, to elicit a response from you, is that what is being done here is irreversible in terms of businesses eliminated. We can talk in terms such as, "We hope we will get a recovery in the second quarter," or "We will have stronger growth in the end of 1982," and so on, but that does not help the man who is going bellyup right now. If it was just a marginal situation, I would agree that obviously maybe one could make the argument for a weeding out. But when you see the figures that are being discussed in the New York Times today and the figures we

know of, that is more than weeding out; that is totally eliminating a good portion of the private sector.

Dr. WEIDENBAUM. I share your concern, and I tried putting it into historical perspective. That is, a period of recession, historically and traditionally, is a period when the failure rate goes up, just as a period of economic growth is a period where the rate at which new firms are started goes up. The sad fact of the matter is that over the years the failure rate of small business in good years and in bad years is very high. That is just the economic facts of life. The survival rate of small business is traditionally low.

We hope we are creating the kind of economic environment for the years ahead when many new firms will be started, often by the same people, and they will grow and prosper. Increasingly, American companies compete in world markets. What seemed to be giants when viewed from an American perspective are no longer the dominant powers in the international markets. In fact, when you rank American companies against the competition in the last decade or two, I am struck by the fact that most of the time American companies have lost their position in the international rankings and their foreign competition has risen in the international rankings.

Then let me, in all candor, raise a point that may not be very popular. But the fact of the matter is that the much criticized provision in the tax law on safe harbor leasing does have the effect of producing a more competitive economy. We usually do not think about that, but since Safe Harbor Leasing was enacted by the Congress, we no longer read so much about companies buying out smaller and weaker companies for tax advantages. The smaller and weaker company can maintain its independence now by selling its tax provisions, without losing its independence. So there are ways of encouraging, and maybe the Congress inadvertently has encouraged, companies to maintain their independence in a period of adversity.

Senator WEICKER. Let me get back to the industry that I mentioned. Again, to make a point, do you believe that it is more difficult today, in light of recent economic events, to start: *(a)* a real estate firm; *(b)* an insurance agency; and *(c)* a brokerage firm. Do you think it is more difficult for an individual or a small group to get started in those industries today than it was 2 years ago? These are small businesses we are talking about.

Dr. WEIDENBAUM. I have not made a specific study. The honest answer is, I really do not know. I am mindful of the fact that we continue to read stories of entrepreneurs, especially in high technology industries, who have formed their companies in recent years and are in major growth phases. So I think that over the years which industries are the growing industries that encourage new entrants, that does vary. It would not surprise me, although I just do not have the facts at my fingertips, if the industries you mentioned, Mr. Chairman, are not currently the growth industries attracting lots of new entrants but that other industries are in the growth phase.

Senator WEICKER. Would you like to start up a car agency at this time? Would you like to start a homebuilding firm at this time? I

am trying to expand as to what is out there. Do you think this is the time to get into those areas?

Dr. WEIDENBAUM. Very frankly, and I have written on this as a private citizen, I think the automobile industry is going to be a smaller part of this economy in relative terms in the 1980's than in the 1970's for very fundamental reasons.

Senator WEICKER. What about homebuilding?

Dr. WEIDENBAUM. I very frankly would make the same comment on homebuilding.

Senator WEICKER. My problem is that we have eliminated homebuilding. We have eliminated the automobile industry. We have eliminated insurance. We have eliminated real estate. We have eliminated brokerage firms.

I think what I am trying to say here is that in every one of these instances you are talking about small businesses. I am only trying to reinforce the point that I made that these economic policies are not going to be without permanent consequences. Never again, believe me, are you going to have the degree of competition that you have had. I think this is something that is overlooked in trying to effect this particular game plan. Oh, the profits of Du Pont or Dow might dip, and they might have some temporary problems, but they are going to be there. What I am talking about, small businesses are not going to be there.

There is the difficulty, in my capacity as the chairman of the Small Business Committee, that I have with an economic policy that might be very good in the overall for big business but is simply just devastating to small business. And even when the recovery comes, the role that small business plays, assuring competition in our free enterprise system, will be a lot less than what it was before this administration's economic game plan.

Dr. WEIDENBAUM. Mr. Chairman, I have not exactly been overwhelmed recently by kudos from big business either. It is not apparent to big businessmen that the policies being pursued are especially directed toward them. I think people realize that we are going through a transition to what we envision will be a healthier economy. Yes, I do expect that a variety of services will continue to be extremely competitive, attracting not only considerable turnover but a considerable amount of new entrants.

Just to cite one example among many, the fast food industry is one that has, in recent years, attracted a great number of entrants. Aspects of the electronics industry likewise. When I look at the demographics of the homebuilding industry—it would be presumptuous for me to say whether the shift would be from single-family to multi-family; we hope that will be determined in the market—the underlying demographics in the 1980's will be very favorable to the homebuilding industry.

I would hesitate to generalize from a transitory, recessionary experience, having lived through so many of them, in terms of the long-term impact of that albeit painful but temporary recession.

Senator WEICKER. This is, however, the severest recession in our lifetime; right?

Dr. WEIDENBAUM. No, sir.

Senator WEICKER. Certainly, in terms of business failures, it is the most severe.

Dr. WEIDENBAUM. In terms of the downturn in the economy—and private economists have made similar forecasts—this is, in terms of the impact on the American people, an average recession.

Senator WEICKER. Before turning to questions from Senator Nunn, since we are looking at what areas of small business might be considered growth areas at the present time, my staff suggests to me that two booming small businesses are collection agencies and inventory liquidators.

Dr. WEIDENBAUM. I thank you for the information.

Senator NUNN. Thank you, Mr. Chairman.

Dr. Weidenbaum, the whole question of financial sector deregulation is one which we are struggling with. I do not know whether it will culminate this year or next year, but the administration is involved in that. We have several different bills before us. What do you see as the effect on small business' ability to borrow, from a liberalization of the Glass-Steagall Act and the McFadden Act, if that occurs?

Dr. WEIDENBAUM. I will be pleased to give you my off-the-top-of-the-head response.

Senator NUNN. Has the administration taken a position on those bills yet, like the Garn bill? It is my understanding that the administration has a position that is slightly different from the Garn bill.

Dr. WEIDENBAUM. Secretary of the Treasury Regan represents the administration in those matters, and I believe he has testified before the Senate Banking Committee on that subject.

Senator NUNN. I am not interested in getting all the details. But, whatever the bill is that emerges, it seems that most of the bills are moving toward having more institutions being able to do more things in the financial sector, and having much more involvement of investment firms in banking, and much more involvement of banking firms in investment. What I am trying to sort out of all that is, has anybody in the administration begun to take a look at the effect of all this deregulation of banking on the small business sector and their availability of credit?

Dr. WEIDENBAUM. My personal evaluation is that opening up the market for competition by more suppliers of that service should improve the prospects for smaller businesses that need that service. My expectation would be that opening up banking services to a wider geographic terrain or industrial terrain, to greater competition, from the viewpoint of the customer, the personal customer or the business customer, I think that on balance the customer's position would be enhanced.

Senator NUNN. Mr. Swain, have you looked at that?

Senator WEICKER. He is back there. He has not testified yet.

Senator NUNN. Let me ask you that question now, if you do not mind. Have you taken a look at that, in your role as the SBA Chief Counsel for Advocacy?

Mr. SWAIN. Yes, sir. We are looking at it with our staff. We have at least two research contracts out trying to determine the level of banking problems of small businesses versus other financial institutions so that we might be able to predict what some of these changes might mean.

Dr. WEIDENBAUM. Senator Nunn, if I might add to that, I pose as no expert in this area, but I am concerned about the viewpoint of

the availability of financial resources to the smaller companies, the problem of the relative monopoly power of the local bank. It is the only financial institution in town. I think that small business looking for new capital, new financial resources, will do better if there is that competition for his or her business.

Senator NUNN. There is certainly competition for funds; there is no doubt about that. The question is whether there is going to be increased competition for making loans to small businesses, and I see those as perhaps to different questions. They may have the same answer, but they may not.

When you create larger and larger institutions, even though there are more of them—for instance, mutual funds, stock brokerage firms—it seems to me that what is happening is that the money is flowing from small communities and small towns up into the highest return, the highest market. Much of it is going into commercial paper, much is going into Government bonds, some of it is going into Eurodollars and that kind of money business. Now, what makes the flow start back down, in terms of the needs of small businesses? The money he has deposited has gone into some higher return investment? What turns it around?

For instance, you have in section 3, chapter 3 of the President's report—and maybe Mr. Swain should address this—that you are going to have a channeling of money to small banks for loans to businesses in different locales that flows out of all this. The question I have is, what in this new environment is going to cause the money to go back down for loan purposes?

Dr. WEIDENBAUM. The basic answer is the competition for that smaller company's business.

Senator NUNN. For the deposit side of it or for the loan side?

Dr. WEIDENBAUM. For both. The thing that strikes me, and I think this has been overlooked too frequently, is that opening up financial institutions to this greater array of competition has done more for the average citizen. My father is in his eighties, living off his social security pension and very modest savings. For the first time in his lifetime, he is now getting a competitive market rate of interest on his modest savings. That only occurred because of the deregulation that opened up the banking business to more competition.

Senator NUNN. I think that side of it is very healthy. I just wonder if we are going to pay a price on the other side of it, and that is the availability of capital in smaller ventures, in home building, in that kind of enterprise. Where are your depositors going to be in the future that are willing to wrap up money for 20 or 30 years at a time?

Dr. WEIDENBAUM. Senator Nunn, I am accompanied this morning by the person who is much more expert on these matters than I am, Dr. James Burnham. May I call on him?

Senator NUNN. We would be delighted to hear from him.

Dr. BURNHAM. Senator, my experience comes from the Pennsylvania banking area, where it is characterized by many communities with small banks, and the questions of providing for the needs of small businesses is very frequently discussed in connection with banking legislation in that State.

I think the record suggests that many of these funds which are not being taken out of these communities by individuals for the money market funds directly in the past typically were deposited with local banks, but the banks then laid off the money in terms of the Federal funds market or in terms of short-term Government securities. I do not think there is any question that local banks, particularly when there is competition in these communities—whether it is from other banks, or now savings and loans who have increased commercial lending powers, and finance companies—these funds are made available to small businesses in a competitive environment.

The question is, do the surplus funds in many of these communities go out directly by individuals to money market funds, or do they go out indirectly via the Federal funds market, as it is administered in the banking industry.

Senator NUNN. Are you saying you think the whole thing will sort itself out, and there will be funds available in the future for small businesses in the small towns of America?

Dr. BURNHAM. I think that in the State of California, where there has been a very massive statewide banking system for many years, if you look at that State, there are more small banks today than there were 5 years ago or 10 years ago. There is a demand and a need for small community banks, and they can exist very profitably, even when financial legislation is very liberal. The California experience is a very good example of meeting the needs of communities, even though you have a very liberal financial system.

Dr. WEIDENBAUM. Can I add to that? The giant California banks, on the average, have provided far more funds to the average homeowner than the States where the banks are much smaller, where you do not have branch banking.

Senator NUNN. California is so unique in every respect, I am not sure that it is typical of anything, but I will accept that analysis.

What do you foresee, Mr. Weidenbaum, in terms of interest rates? What is your basic forecast on the behavior of interest rates in the next 6 to 9 months, let us say between now and the end of this calendar year.

Dr. WEIDENBAUM. My forecasting record for the past year does not inspire great confidence, I will have to candidly remind the Senator. I think because inflation has come down so substantially, I expect that the trend of interest rates will be down. As I point out in my opening statement, interest rates do not move in a straight line. They are running true to form now.

But given the fact that we have moved from an escalating double-digit inflation of 12 to 13 percent, the inflation rate that is currently half of that, interest should—and I expect will be coming down—but they will stay high by historical interest rates, because those real interests, what is left after you pull out the inflation premium in the interest rates, are high because of deficit financing around the world, including the United States but not limited to the United States. Western Europe and Japan are all operating at very substantial deficits, and that puts tremendous pressure on the world financial markets and keeps real interest rates in this globe high.

Senator NUNN. They are not high in Japan. How do you distinguish Japan from the rest?

Dr. WEIDENBAUM. I am talking about real interest rates. Market interest rates, of course, are a function in good measure of the inflation experience of that country and its monetary system. Of course, quite clearly, Japan has a much higher savings rate than we do. We have just about the lowest of any developed nation.

Senator NUNN. I recognize that, and I also agree it is a major problem. I think probably the most important part of last year's Tax Act was the incentive for savings.

Dr. WEIDENBAUM. Yes, sir.,

Senator NUNN. What is happening with the saving trend right now. What do the latest statistics you have indicate, compared to several months ago?

Dr. WEIDENBAUM. The first 9 months of 1981, the personal savings rate averaged about 5 percent. In the fourth quarter, following the enactment of the first installment of the personal tax cut and lower inflation, the personal savings rate rose to 6 percent. It has backed off that peak since the opening months of this year, fluctuating between 5 and 6. I expect that in July when we get the 10 percent personal tax cut, it will shoot up again and very frankly, this is the pattern that the savings rate has followed every time the tax rates have changed up or down. The initial impact comes heavily in or out of savings, and some of that moves in or out of consumption, depending on whether it is a tax cut or tax increase. Still, after a tax cut, the savings rate tends to be higher than it was before the tax cut. But the initial impact is higher, and the lag is in there.

Senator NUNN. Dr. Weidenbaum, one of the most important sectors to small business is housing, and not just housing directly but everything affected by housing. There are many different industries affected by housing, of course. If you take the totality of it, that is the heart of the small business community, in my view. What level of long-term interest rates do you foresee would have to occur for housing to have a sustained recovery?

Dr. WEIDENBAUM. I do not think there is a magic rate.

Senator NUNN. Let us say a range.

Dr. WEIDENBAUM. A 2- to 3-percent reduction in mortgage rates would be very helpful.

Senator NUNN. You are talking about getting long-term home rates down to 13 percent? Do you believe we can make it on 13 percent? Do you think we can have a sustained recovery?

Dr. WEIDENBAUM. Frankly, I would not forecast a boom. But a 2- or 3-percent reduction from these painfully high mortgage rates——

Senator NUNN. They are 16, 17, and 18 now. So you are talking about 13, 14, 15?

Dr. WEIDENBAUM. That certainly would enable good recovery to get underway. As it is, we are projecting a very modest upturn in new starts, as 1982 unfolds. In fact, if you look at the data in the last few months, you see that starts permits have begun a very modest upturn; nothing to crow about. The data hit bottom several months ago, and startup permits were up about 6 percent annual rate last month.

Senator NUNN. I agree with you completely that savings is one of the keys to sustained economic recovery. We have to increase savings, and I think the IRA accounts will begin to do that. But if savings are that critical—you have said that, and I agree—why not take the 1983 individual tax cut and turn it into a savings incentive instead of just a tax cut that will be there no matter what the money is channeled into?

I never have understood the President's argument that individual tax cuts were going to cure the capital investment/savings sort of thing. The Keynesians have been saying for years that individual tax cuts went into consumption, and all of a sudden we have supply-side economics, and somebody has the same kind of tax cut and says it is going to go into savings. I do not understand that.

Dr. WEIDENBAUM. Sometimes listening to some of my private sector friends, I hear them say that tax cuts will do everything, including dealing with my incipient baldness. But I do think that the across-the-board reduction in the high and marginal rates differentiate the 1981 tax act from the earlier, more consumption oriented tax cuts. That, I think, is the heart of the difference.

For example, a $50 or $100 cut in everybody's income tax bill does a lot for consumption but does nothing to provide for any additional incentive for either work effort or savings and, hence, investment. So this is a supply-side oriented tax cut. This is why I expect it, as it demonstrably already has, will have a bigger boost for savings than past tax cuts.

But the fact of the matter is, given the nature of our tax system, the absence of these personal tax cuts, the average citizen's Federal tax burden would be rising. There is an important matter of equity here. Perhaps the ultimate in tax reform was this kind of across-the-board tax cut that prevents what has been in the past a steady rise in the average citizen's tax breaks.

Senator NUNN. Let me just ask one other question, because I have taken enough time now. Is the Federal Reserve policy, as being implemented now in the last 6 or 9 months or year, generally endorsed by the administration? Does the administration have a fundamental disagreement with the Federal Reserve program as it is now being implemented?

Dr. WEIDENBAUM. We have consistently supported the Federal Reserve's stated policy of gradual, moderate growth in the money supply. In the administration, we have stated our support for their targets. Sometimes, very frankly, we have made some public and private comments about their ability to achieve their targets. I have said I hoped that their aim improves, but that is not meant as a criticism because they share that view.

Senator NUNN. Would that not mean that they have to tighten down now in order to get back down to their targets after the first several months of this year? Would your criticism now be that the Fed does not have tight enough money?

Dr. WEIDENBAUM. No, I would not say that.

Senator NUNN. But they are overshooting their targets for the first 3 months; right?

Dr. WEIDENBAUM. Yes. I do not think they have been giving a very clear explanation of what happened. I think it took them by as much surprise as it took the rest of us.

Senator NUNN. But you are saying now that even though they are over their targets, the administration agrees that they should be over their targets?

Dr. WEIDENBAUM. I am not trying to second guess their specific performance.

Senator NUNN. You reserve the right to criticize later if it does not work out; is that it? It seems to me that no matter which side of their target they are on, the administration is criticizing them for being not on their targets. But I am giving you a chance to say they are not on their targets now. They are not are they?

Dr. WEIDENBAUM. We have been very consistent. As I look back at this administration, every time the Federal Reserve has been consistently over its targets, we have called that to their attention and wished them well in getting back on target. But every time they have been consistently below the target, we have called that to their attention and likewise wished them well on getting back on target.

Senator NUNN. Well, are they not over their targets now?

Dr. WEIDENBAUM. I see they are making a very proper effort to get back into the target range, and I wish them well.

Senator NUNN. So you wish them well in tightening the money supply?

Dr. WEIDENBAUM. I would not call that tight.

Senator NUNN. What do you call it?

Dr. WEIDENBAUM. Moderate growth money supply, which is succeeding over the period since January 1981 in squeezing out the tremendous inflation in this economy and reducing the inflation premium and interest rates. The prime rate, as you know, has gone down from 21 percent to 16½ during this period. That is not enough, but it is certainly a move in the right direction.

Senator NUNN. I appreciate your making the administration's policy on the Fed's current overshooting of its targets perfectly clear, Dr. Weidenbaum.

Dr. WEIDENBAUM. I am delighted.

Senator NUNN. I understand it completely.

Mr. Chairman, I want to put my opening statement in the record and submit some other questions. I have to go to the Armed Services Committee meeting right now, but I appreciate your having these hearings.

Senator WEICKER. Any further questions will be submitted to the witness for a response for the record.

[Material follows:]

OPENING STATEMENT OF SENATOR NUNN

HEARINGS ON THE PRESIDENT"S REPORT ON SMALL BUSINESS

MARCH 31, 1982

Mr. Chairman, these are important hearings that are being held today. In 1980, as part of a comprehensive legislation dealing with small business, and the Small Business Administration, the Congress enacted the "Small Business Economic Act of 1980". That Act, and title IV of Public Law 96-302, in tandem, were passed in part because of a long-standing Congressional concern that major policy initiatives of any Administration rarely took into account the impact of such initiatives on small business.

In 1978, for example, at oversight hearings held by this Committee, I asked then SBA Deputy Administrator William Mauk whether SBA was formally requested to comment on several Carter Administration legislative initiatives, such as the 1978 tax proposals, or the increased minimum wage proposal, or the social security reform legislation. Mr. Mauk answered that "the Small Business Administration was not formally asked for comments on (any of these) Carter Administration proposals...". In April, 1979, during this Committee's review of the President's multilateral trade agreement program, former Senator Morgan asked SBA Administrator Weaver whether SBA had been consulted during the negotiating and drafting of the MTN; the Administrator answered a simple "no".

These provisions were designed to provide the Executive Branch, Congress, and the Small Business community with the impetus to organize the vast amount of information on small business and utilize these tools to thoroughly and effectively analyze the current state of small business, and the impact of major proposals on them.

On March 1, 1982, pursuant to that law, the President transmitted to the Congress the first "State of Small Business" report. At the White House ceremony to witness the signing of the report, the President told over 150 small business men and women:

> "We'll be urging the Congress to read and act on the report, not bury it, and you have my pledge that small business will never be relegated to a back seat, not in this Administration."

Mr. Chairman, I want to commend you for holding this hearing just a few weeks after the report was released. I have reviewed the President's message, and intend to study the report more closely during the next several weeks.

As the ranking minority member of the Committee, and on behalf of my colleagues on this side of the aisle, I welcome the President's call for debate and action on his report, and pledge our diligence in reviewing the recommendations.

I also welcome the President's commitment to small business, and to the position small business will occupy for this President, and this Administration.

In addition to the President's message on small business, I have found the accumulation and compilation of data on small business in the appendix to the report prepared by the Small Business Administration to be about the best single source of statistics on small business. I am confident that the statistical base will go a long way to assist the Executive Branch, this Committee, and the Congress, in analyzing the impact of a wide range of policy recommendations on small business. SBA, and the Office of Advocacy, deserve a great deal of credit for their work in this area.

Mr. Chairman, I would hope today's hearing will open the door to a dialogue between this Administration and the Congress on the very significant economic crisis facing our Nation's small business community. Yesterday, we introduced a resolution in the Senate calling on the President to designate the week of May 9, 1982 as "Small Business Week". I can think of no more fitting tribute to our nation's largest segment of the business community than to demonstrate to them that we are truly concerned about their chances of survival; that we recognize the factors that are contributing to their current financial squeeze, and that we, as a National Government, Congress and the Executive, will commit ourselves to work together on a course of economic recovery on their behalf. Time is of the essence. The President's report on the "State of Small Business" can be the catalyst. A healthy economy, with a vibrant small business sector, can and must be the result of our joint effort.

Thank you Mr. Chairman.

LOWELL WEICKER, JR., CONN., CHAIRMAN
BOB PACKWOOD, OREG. | SAM NUNN, GA.
ORRIN G. HATCH, UTAH | WALTER D. HUDDLESTON, KY.
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United States Senate
COMMITTEE ON SMALL BUSINESS
WASHINGTON, D.C. 20510

April 2, 1982

Mr. Murray L. Weidenbaum
Chairman
Council of Economic Advisers
Executive Office Building
Washington, D. C. 20506

Dear Mr. Weidenbaum:

In follow-up to the Senate Small Business Committee's March 31, 1982 hearing concerning the President's first Annual Report to the Congress on "Small Business and Competition," I would appreciate it if you would provide responses to the attached questions for the hearing record.

Thank you for your timely consideration.

Sincerely,

LOWELL WEICKER, JR.
Chairman

Enclosures

THE CHAIRMAN OF THE
COUNCIL OF ECONOMIC ADVISERS
WASHINGTON, D.C. 20506

June 14, 1982

Dear Senator Weicker:

Chairman Weidenbaum has asked me to submit the attaached questions and answers to you. They are in response to your request for additional answers for the record in conjunction with his March 31, 1982, appear before your committee.

Sincerely,

Eric Hemel
Special Assistant
to the Chairman

Honorable Lowell P. Weicker, Jr.
Chairman, Senate Select Small
Business Committee
Room 424, Senate Office Building
Washington, DC 20510

95-392 O - 82 - 3

Weidenbaum Questions and Responses for Senate Small Business Committee

Q1: To what extent, if any, will financial sector deregulation affect the ability of small firms to obtain credit at affordable rates?

Could you elaborate in the context of a liberalization of both the McFadden and Glass-Stegall Acts?

A: The deregulation of financial markets should benefit small business. No doubt, not all firms will be affected equally by this process. Increased competition in financial markets will facilitate the movement of funds from creditors to debtors. One of the important results of deregulation will be that firms can serve specialized segments of the market. The present restrictions prevent firms from obtaining the economies that may be possible in certain specialized activities such as making loans to small business. A small bank may not have the ability to investigate the unique problems of small businesses and provide them with guidance as well as funds. However, a national firm that specialized in the financing of small businesses could provide services to small firms that are not available from the local small bank. On the other hand, if a small business has a close relationship with a small bank which decides to merge with another bank due to bank deregulation, then it might lose that special relationship and be hurt.

Experts in this area have questioned the desirability of the provisions of the McFadden and Glass-Stegall Acts. Restrictions on interstate branching and the separation of commercial and ivnestment banking have questionable benefits and potentially high costs. The Administration has submitted its own bill, "The Bank Holding Company Deregulation Act", as a companion for the Financial Institutions Restructuring and Services Act of 1981 to address these concerns.

Q2: In your opinion, is small business more in need of an improved flow of equity or debt capital?

How would it be accomplished?

A: Small business should have an equal access to the capital markets. All sizes of firms have been adversely affected by the slowdown in the savings rate. This Administration has attempted to reverse that process through the Economic Recovery Tax Act of 1981 which is covered in detail in Appendix E of the Report. As between equity and debt financing, that is a decision to be made in the financial markets. We are less concerned with how businesses decide to finance their activities, as with the level of funds that are available.

Q3: Do you feel that the huge amount of money tied up in pension funds should be tapped as a source of business capital?

How could this be done?

Would you recommend a rewriting of ERISA to permit greater use of pension funds?

A: The overwhelming majority of private pension fund assets are currently invested in business capital. The Administration has taken steps to make these investments more productive by proposing to ease regulations on the types of investments that pension fund managers are allowed to make. Current Federal regulations designed to prevent conflicts of interest in this area are needlessly cumbersome and restrictive. The class exemptions from these restrictions that the Administration has proposed for professional asset managers such as banks, insurance companies, and registered investment advisors will reduce unnecessary paperwork and increase rates of return on pension assets without endangering the safety of these assets.

Q4: In the Report (Section I, Chapter 4) it was mentioned that private pension plans need to be encouraged to increase the goal of national savings. How would you encourage small firms to offer pension plans for their employees?

A: Our current tax system provides substantial incentives for firms to establish private pension plans, and a large percentage of both large and small businesses have done so. Numerous banks and insurance companies are willing and able to provide small firms with technical assistance in setting up plans best suited to their own needs and those of their workers.

Last year's tax legislation provided an additional incentive to private pensions by allowing employees who are plan members to contribute to Individual Retirment Accounts. These IRAs can either be managed separately, or can be combined with the group plan at the employee's place of work.

Q5: In the Report (Section III, Chapter 3), only one short paragraph was devoted to the impact of budget deficits on the financing needs of small business. Could you tell me whether or not, in your judgement, high budget deficits have a disproportionately adverse effect on small business?

A: As I indicated in my prepared statement, the deficit is still too high. To some extent, the large deficit will have to result in some private borrowers being priced out of the market for investment funds. I am not aware of any evidence that small business is subject to a disproportionte share of the adverse effects of this crowding out.

Q6: In the report (Section III, Chapter 3), it was stated that in the financial sector, a new environment was foreseen where deposit funds will be collected by large numbrs of large financial institutions, such as banks, mutual funds, and stock brokerage firms, which would then be channeled to small banks for loans to businesses in different localities. Could you explain how, in this new environment, funds would be tranferred from large banks to small banks?

A: It is important to bear in mind that the flows at the present time are from the small banks to the large banks. In the cases where the flows are in the reverse direction, a number of alternatives presently exist and new opportunities will come with deregulation. First, through their correspondent relationship, small banks can borrow from larger banks, and then loan out the funds locally, making a profit on the spread. Second, for short term funds, the small banks can use the Federal funds markets. A new avenue, that could open up with deregulation, would be by selling large denomination certificates of deposit to money market funds operated by larger banks.

Since investment funds are a highly fungible good, they will easily move to their highest valued use. If that use is provided by small banks, then the funds will flow to that

sector. However, large banks may be just as capable, if not more so than small banks, in meeting the needs of small business.

Q7: In the recently completed study on small business finance which was prepared by the Interagency Task Force on Small Business Finance, it was recommended that commercial banks should be encouraged to begin adding borrower size information to their computer files. In your opinion, do you feel that it would be beneficial to speed up the collection of such information?

A: Information on the size of borrowers would be interesting, however, this Administration is attempting to reduce the paperwork burden on American businesses, so this program should be limited to voluntary compliances.

Q8: Do you interpret the decline in the share of GNP accounted by small business as a temporary phenomenon or as an indication that forces are at work that are leading to a secular decline in the macroeconomic role of small business?

A: There is no clear explanation for the decline in the share of GNP accounted for by small business. As stated in the Report, the major shifts between 1958 and 1977 were that the very smallest firms' (0-19 employees) share of sales declined from 30.9 to 21.2%, while the largest increase was among the largest firm (5,000 or more employees) which grew from 25.7 to 33.6%. The shares for most of the sizes in beween remained reasonably constant.

If this shift is due to policies that bias the economic system in a manner that reduces the ability of small firms to compete, then some policy adjustment may be required. However, if the evolution of our economic system has increased the efficiency of large firms relate to small firms, then this is a process that should be encouraged.

Q9: While small business may have behaved as a "shock absorber" in previous business cycles by maintaining a given level of employment in the face of recessionary pressures, this is clearly not the case this time around.

How would you interpret this break with past behavior?

A: Most firms are adversely affected by a down turn in economic activity. However, durable goods manufacturers tend to be more adversely affected than the producers of non-durable goods since it is more difficult to forego the consumption of non-durable goods. One way of looking at the employment situation in small business during ar ecession is to call it a "shock absorber". Another way to analyze the situation in small business is to point out that small, labor-intensive businesses tend to produce non-durables which are less sensitive to the business cycle. It is not clear why the effect on small business should be different in this recession.

Q10: If savings is so critical, why shouldn't we require that future individual tax cuts (July, 1983) be tied to some savings requirement before an individual receives it?

A: Many people have argued for taxes on consumption rather than on income as an attempt to increase savings. These proposals have to be given serious consideration. To require a level of savings before individuals would qualify for a tax cut seems unnecessarily complex. Reducing the high marginal rates plus reducing inflationary expectations are a potent combination of saving incentives.

Q11: Does the Adminsitration plan to introduce measures that will explicitly seek to further increase the nation's pool of savings?

A: It would appear to be a wise course of action at this time to permit the provisions of the Economic Recovery Tax Act of 1981 to have an opportunity to induce an increase in the saving rate.

Q12: Studies show that small businessmen see the greatest barrier to starting a new business is the lack of start-up capital. However, the President's enterprise zone proposal which was submitted last week offers no direct incentives to lenders to make that start-up capital available. Rather, the Administration's plan depends on tax incentives to the enterprise zone business itself, and federal and local

deregulation to increase the chances for business success. Considering the risk of lending money to new businesses in depressed areas, does Congress need to do more to insure that the needed start-up capital will be made available to small businesses who want to locate in a designated enterprise zone?

A: The focus of all government policies toward small business should be on removing barriers that unfairly burden small businesses. However, the government should not focus on providing small business with favorable treatment relative to other sizes of businesses in situations where there is no evidence of a preexisting bias against small businessses. The President's enterprise zone proposal can be an important program. It presents a new challenge for all businesses, including small businesses.

Q13: In the President's economic report for 1982, a rapid recovery in the housing sector is forecasted to begin in the spring and proceed through the remainder of the year. Spring has officially begun but due to high mortgage rates, still averaging about 17 percent, the housing recovery does not seem to be developing. Do you have a new forecast for recovery in the housing sector?

And, at what level of mortgage interest rates do you feel a housing recovery can begin?

A: We continue to forecast a recovery in the housing industry that will be apparent during the spring. Already housing permits have started to increase. Mortgage rates along with other long term interest rates have remained at unacceptably high levels. However, we continue to expect that they will decline along other long term rates over the

remainder of 1982. There is no unique threshold where the demand for housing will increase dramatically. There can be no doubt that a lower mortgage rate will be very helpful in producing a recovery for the housing industry. The present policies of this Administration will help to produce lower interest rates.

Q14: In the statement accompanying the Report on Small Business and Competition, the President indicates that the American economy is "critically dependent upon preservation of real opportunity for small business." Further the President acknowledges that small businesses are responsible for almost half of the production of goods and services in the economy, that they produce more innovation per research and development dollar, that they are among the leaders in employment creation and that they play an important role in providing economic opportunities for minorities and women.

As a matter of economic policy, should small business be recognized as a separate and important economic sector or should we assume that what's good for all business will wind up being good for small business?

A: When analyzing the role of small business in the U.S. economy, we must not be confused by cause and effect relationships. Changing economic demands result in new jobs being created. If that growth is in areas where small businesses have unique advantages, then the new jobs will be in small businesses. It is not the small businesses that created

the jobs but the economic growth. For example, the service sector has been an important area of growth over the last decade. Small businesses have advantages in the labor-intensive service sector. Therefore, the new jobs have appeared in small businesses. If the growth in demand nad been for trucks and cars, the new jobs would have appeared in large companies.

Small business is more efficient than large business in providing certain products. This Administration is committed to providing small business with a fair opportunity so that it can grow and prosper in the areas for which it is uniquely qualified. The key to growth for small business is growth for the overall economy.

Antitrust Questions and Responses for Senate Small Business Committee

Q1: In his recent message to Congress on the state of small business, President Reagan has stated that "small businesses rely upon the free functioning of markets to compete and prosper." (President's Report at 15) The President went on to state that "The Attorney General will vigorously prosecute anti-competitive behavior". (Report at 16) The May 7, 1981 Wall Street Journal quoted William Baxter, the Administration's chief antitrust enforcement official as saying that he views "large companies as very valuable things ...partly because they perform some tasks more efficiently than smaller ones." The July 8, 1982 Wall Street Journal repeated that quote and added Baxter's words that large firms "tend to be the most efficient."

Assuming for the moment that the Administration will be able to limit its antitrust enforcement activities to situations where efficient companies have been the victims of antitrust violations, what do you think antitrust enforcement policy should be when the government is presented with an antitrust claim by a small company concerning its large competitor if that large competitor can justify its conduct on the basis of economic efficiency? Stated another way, in your view, should the President's promise to "vigorously prosecute anticompetitive behavior" be tempered by demonstrations of greater efficiency of large enterprises, as Mr. Baxter has suggested.

A1: A number of the antitrust questions that you have submitted to me require legal opinions which are beyond the areas of expertise of CEA. Since you have made a similar set of requests to SBA, which does possess a legal staff, where appropriate I will be deferring to their responses to your antitrust questions.

From an economic perspective, the goal of antitrust policy should be the maximization of consumer welfare as so well argued by Robert Bork in The Antitrust Paradox. This process would result in an array of firms depending upon the relative efficiencies of different sizes of firms in the different industries. Where appropriate, the firms in an industry may be small, while in other cases the firms in an industry may be large.

Q2: In an interview reported in the August 3, 1981 U.S. News and World Report, Mr. Baxter was asked the following question: "Do small firms have anything to fear from this Administration's enforcement of the antitrust laws?" Mr. Baxter's answer was as follows: "To the extent we succeed in enhancing the efficiency of some industries by administering a more coherent, economically based, efficiency-oriented version of antitrust, price levels will fall, and some small enterprises will probably be squeezed out of those markets." What would you do for the efficient small enterprises that are squeezed out of the market as a result of Mr. Baxter's new antitrust philosophy?

A2: Efficient producers are the lowest cost producers, so efficient small entrepreneurs have nothing to fear from an effective enforcement of the antitrust laws.

Q3: Do you agree with the views expressed by the Supreme Court in the Brown Shoe case as follows: "It is competition, not competitors which the Act protects. But we cannot fail to recognize Congress' desire to promote competition through the protection of viable, small, locally-owned businesses. Congress appreciated that occasional higher costs and prices might result from the maintenance of fragmented industries and markets." If you accept this language of the Supreme Court concerning Congress' motivation in passing the Sherman Act, do you believe they square with Mr. Baxter's views?

A3: The CEA is not in a position to analyze the views of the Supreme Court from a legal perspective.

Q4: In the SBA's Annual Report on Small Business and Competition it is stated that many observers "increasingly have come to recognize, in some instances that vertical restrictions can have beneficial effects." (Report at 175) This comment is extended by noting that the Supreme Court has held with respect to intra-brand restraints that restraints other than resale price maintenance "should be judged permissible elements of a marketing system unless clearly shown to have an anticompetitive effect." The Report than cites the G.T.E. Sylvania decision in support thereof. (Report at 176) Will you submit for the record the language in G.T.E. Sylvania which says that non-price vertical restraints "should be judged permissible" unless "clearly" anticompetitive.

A4: In this question, you are referring to a part of the Report written by SBA, which requires a legal analysis. Since they wrote that section, they are the appropriate source of the language that you request.

Q5: Referring again to the same portion of the Report on Small Business, at 197, is it correct to say that resale price maintenance would be viewed as illegal under the Sherman Act? If so, do you agree with Assistant Attorney General Baxter's comment, as quoted in the Wall Street Journal of May 7, 1981, that in many circumstances practices such as resale price maintenance "are the most efficient ways of doing business" and that "legal precedents against those efficient arrangements harm consumers by driving up costs and prices."?

A5: Although I cannot present a legal interpretation of the Sherman Act, I can say that economists have come increasingly to realize that there may be losses in efficiency due to restrictions on voluntary vertical agreements, such as resale price maintenance. Vertical integration of activites exists in many forms all the way from executives who do not type their own letters to firms that produce and sell their own products. These decisions are usually driven by the fact that they are the lowest cost method for producing a given result. The arrangement can be internal to a firm or external by agreement. For example, a manufacturing firm wants his dealers to have an incentive to provide service for the product. Now, if the dealer knows that other dealers will be able to eventually come into his territory and change low prices and offer no service then the present dealer is going to be reluctant to change a high price and offer service. It is in the best interest of the manufacturer, the dealer, and

the consumer, that quality service be available. Although consumer's may have to pay a higher price for the product, there are still competitive alternatives that will limit the adverse effects of this restriction.

Q6: The SBA Report seems to argue that for some small manufacturing enterprises, non-price vertical restraints would be helpful just as they are helpful to the small manufacturer's large competitors. Do you think the same policy should apply to small business enterprises that do not engage in manufacturing but rather provide services or distribute products? Do you have any data on the breakdown of small business enterprises among manufacturing and non-manufacturing categories? If so, do you have an opinion on the relative value to the small business community of advocating a more liberal vertical restraint policy than is allowed by the present law? Stated another way, overall in your opinion would small business benefit by liberalizing the antitrust rules with respect to vertical relationships?

A6: Again, you are asking me to comment on conclusions reached by SBA in an area in which they are more of an expert than we are. First, I do not know of a reason why we should differentiate between manufacturing and service firms as to the effects of vertical restraints.

Charts on pages 186 and 205 of the Report, provide the information for which you are looking.

To say that a policy should be more liberal, one has to be knowledgeable about its current status. We are not in a position to analyze the Department of Justice's policy toward vertical restrictions from a legal perspective.

I think that our antitrust policies should be a subject of continuing analysis. However, I do not believe that there

is any need for a special study of the impact of current antitrust policy on vertical restrictions.

Q7: The SBA's Report states that "vigorous" enforcement of the Robinson-Patman Act is a general concern of small business. The Report then cites Professor Scherer's comment that small business has borne the brunt of the FTC's Robinson-Patman enforcement effort. (Report at 176-77) Isn't it true that while Professor Scherer may be right, his quote does not support the Report's conclusion based on the Professor's statement that "there is little evidence that the Act's enforcement generally has benefitted small business?" Is the Report, in effect, advocating a decrease in Robinson-Patman enforcement actions?

A7: Since this section was written by SBA, I think that it would not be proper for us to second guess their interpretation.

Q8: Concerning Robinson-Patman, the SBA Annual Report does seem to state that price discrimination should be prevented by use of the Robinson-Patman Act (Report at 177) How do you square this comment with the comments of Assistant Attorney General Baxter that the Robinson-Patman Act is a "dreadful piece of legislation?" (Dun's review, August 1981). That it is full of "absurdities" (American Lawyer, July 1981), and that it is an "unjustified protection for small business from the rigors of competition" (New York Times, April 26, 1981).

A8: Here you are asking for an opinion about SBA and Department of Justice statements that require legal expertise that CEA does not possess.

Q9: In cases of predatory practices of large firms against smaller firms involving price, do you believe that use of the Robinson-Patman Act should be abandoned in favor of using Section 2 of the Sherman Act?

A9: This is a legal question.

Q10: Some small business groups such as the Small Business Legislative Council, have criticized the antitrust enforcement philosophy of Assistant Attorney General Baxter and Federal Trade Commission Chairman Miller, especially as that philosophy applies to the Robinson-Patman Act. If a consensus should develop among the small business community that the Administration's present antitrust philosophy does not serve the interest of viable and vigorously competitive small busineses, do you believe the Counsel for Advocacy should step in to fill the antitrust enforcement gap?

A10: This question addresses internal SBA policy about which CEA is not qualified to respond.

Senator WEICKER. Dr. Weidenbaum, I have to take issue with you here on this matter of "squeezing inflation out." We are squeezing a lot of people out. One of the reasons why inflation is dropping is that people in small businesses are going belly-up. I will certainly concede that a portion of the decline in inflation is due to the economic policies of the administration. But, I think the rapid decline we are seeing right now has more to do with the recession we are in, and the detrimental economic effects it has on individuals and corporations, than on a well thought-out economic policy.

Dr. WEIDENBAUM. The facts of the matter are twofold. One, declining inflation started before the recession; and two, recession invariably puts downward pressure on prices, so the progress on inflation was accelerated by the recession.

Senator WEICKER. Let me just ask one question on housing and then I will turn the hearings over to Senator D'Amato. In February, sales of new single-family homes dropped sharply by 11.8 percent, from January's level to a seasonally adjusted annual rate of 336,000 units. February's rate was more than 34 percent below the 511,000 rate recorded in February 1981, and is the second lowest rate recorded since the Commerce Department began keeping these statistics in 1963. At the end of February 268,000 new unsold homes were on the market, more than a 10-month supply at February's rate of sales. If you multiply the 268,000 by the average selling price of a new single-family home, $66,500, you realize that homebuilders are carrying $17.8 billion in inventory that is not moving. Builders are financing that inventory at say, an average of 19 percent, and homebuilders are paying more than $280 million per month in interest alone to carry the inventory of unsold new homes.

I would like you to address yourself to that situation, especially in light of the fact that we do have large deficits, which you say you are against. If indeed we have standing behind the Government waiting to go into the borrowing markets, as I think you will agree, a pent-up demand by the private sector; if indeed we have standing behind the private sector the State and local communities, by virtue of the shift in philosophy away from the Federal Government doing everything, I would like to know exactly what is going to happen, in terms of this segment of our economy? I do not see that there is any way that mortgage interest rates are going to come down. I see the inventory sitting out there, and I see the interest piling up on that inventory.

Dr. WEIDENBAUM. To say I share your concern is such an understatement. I am the owner of an unsold house in St. Louis, renting at a loss. I am one of the many victims of those high interest rates and distress in the housing industry.

Senator D'AMATO. So is one of your students on my staff here. He is not even able to rent his house in De Kalb, Ill. He may have to get a new job, too, because he cannot afford to support that unlived-in-house with this job.

Dr. WEIDENBAUM. I know that feeling, Senator, very much.

Senator D'AMATO. But what are you telling the President?

Excuse me, Mr. Chairman.

I just have a feeling that you people are all telling him, "Mr. President, everything is wonderful." I think the President's broad

economic goals happen to be correct. I think that there are some people who are around the king who are afraid to tell the king that maybe some of the clothing he should have on is not on. You remember that story, do you not?

Dr. WEIDENBAUM. Yes, sir.

Senator D'AMATO. I have been accused of not having all the finesse to address it in a senatorial way, but I just remember that story. Those who forget history are doomed to repeat the mistakes that have taken place in the past.

I want to tell you, Murray, I do not know if you are giving him the bottom line. I do not know what a lot of you people are doing. You all talk about cutting, cutting, cutting. You could knock out all the discretionary funds for this year—everything. Let's eliminate every single dollar in education, every single dollar in all the other discretionary areas. Let us cut them all out, and what do you have: $90 billion? If you do not do anything in terms of entitlements and in terms of social security and suspension of the COLA's and right on down the line, we are going to continue this fiasco. Now, somebody up there is not giving the boss man, who is a good and decent man, the facts.

Do you want to blame the Federal Reserve? That is a lot of nonsense. You cannot come in and blame them 1 day, and on another day say something else; say no, yes, no, tighten, don't tighten money. This is nonsense, and I want to tell you something: I think it is the advisers around the President who are giving him the business. They are not giving him the bottom line.

Dr. WEIDENBAUM. I cannot speak for the other advisers, but I can assure that I have consistently, to the best of my ability, told it straight, reported the bad news just as much as the good news, indicated the hard decisions that have to be made. But if I am going to maintain my effectiveness as an adviser, what I tell the President, of course, has to be a matter between him and me.

Senator D'AMATO. I am not going to ask you what you tell the President. What about an oil import tax on foreign oil: Are you for it or against it?

Dr. WEIDENBAUM. I have stated in public that if Congress is going to pass an oil import fee, the time would be now, given the weak state of the world energy markets.

Senator D'AMATO. What about the impact this would have on the financial community: Raise $12 billion and use it to reduce the deficit, instead of suggesting budget cuts that you know are not going to be achieved, unrealistic cuts you put in the budget as padding.

Dr. WEIDENBAUM. I would have to say that it would have precisely the effect that you indicate, Senator.

Senator D'AMATO. That is a pretty good effect, is it not?

Dr. WEIDENBAUM. Yes, sir.

Senator D'AMATO. What about the suspension of some of the COLA's: Are you for that or are you against it. I am not asking you what you told the President. I am asking you what you feel. I say I think we should suspend the COLA implementations for a period of time.

Dr. WEIDENBAUM. That certainly would reduce the deficit and have a positive effect on financial markets and, I think, help bring down interest rates.

Senator D'AMATO. If we were then also to enact legislation dealing with entitlements, for example, limiting them somewhat, what effect would that have on the long-term bond market: Positive, negative, or nothing?

Dr. WEIDENBAUM. Extremely positive, it would be very good news.

Senator D'AMATO. My God, why not get up some place and start talking about that? That is what we have to do. What are we doing here? I think this is fairyland, pure fairyland. Everybody goes around saying that we should do it, and nobody does it.

Dr. WEIDENBAUM. Senator, one of the things I find not terribly heartening is that despite all of the concerns about the deficit—and it is much larger than I would like it to be—the specific actions on the President's budget proposals in the Congress so far have not been in the direction of cutting the deficit, unfortunately, but to increasing the deficit.

Senator D'AMATO. Let us be a little more specific. Give me two or three illustrations, and then I will give you a couple from my perspective.

Dr. WEIDENBAUM. I am referring to the actions on the appropriations requests. I will be glad to give you a little detail.

Senator D'AMATO. You mean the requests for this year?

Dr. WEIDENBAUM. Yes, sir.

Senator D'AMATO. What would you expect us to do? You know we are caught in an incredible dilemma. Suppose we gave you the whole budget, carte blanche, just the way you want it.

Dr. WEIDENBAUM. Including the $34 billion of revenue raisers?

Senator D'AMATO. Everything. Everything. You have it. Obviously now we are really in a mythical land, an incredibly mythical land. But, we are talking about the king with no clothes. So, starting with that perspective, you have it enacted. What is it going to do to interest rates?

Dr. WEIDENBAUM. I think that certainly would be constructive.

Senator D'AMATO. Would it drop interest rates a point, maybe? What is it going to do to the bonds market? Does it stop the projection showing the trend line going up in terms of deficits?

Dr. WEIDENBAUM. Not by itself.

Senator D'AMATO. What is Wall Street going to do? You are an economist. You are going to advise your people. If we take your budget and your proposals for cuts and your revenue enhancement proposals—not "yours"; those, because this is not personal. You know that I have deep respect for you and for your student, Professor Ray, who injects me with all these formulas that he said he learned from you as your student. I said to him, "I hope you are a little more accurate than some of the economic forecasts we have been getting here, professor."

Suppose we adopt the budget as is, as proposed, with the revenue enhancement measures and so on. You are now not working for the President; you are out there advising clients. Are you going to advise them to invest in the bond market as a result of that kind of

action? Do you think that is going to bring about confidence in the marketplace and financial institutions if that is all we do?

By the way, you are asking for a lot. You are asking for cuts in the guaranteed student loan program, a myriad of other programs to be cut, revenue enhancements that, as you know yourself are making people in the business community jump up and down and be absolutely aghast and furious. But let us suppose we do it all. What is it going to do? Will it produce a healthy bond market? Will it drop interest rates signficantly?

Dr. WEIDENBAUM. I think it would be viewed as a constructive move. The reason I am not going beyond that, Senator, is that next month we will be submitting, as required under the budget process, an updated estimate of the budget results. We are busily at work on that right now, and I do not want to prejudge what the conclusion is going to be.

Senator D'AMATO. Let me give you what you asked for, and that is the Congress enacting those requests that you have made on the budget. Assume you have it, but let me give you another scenario. Maybe $15 or $20 billion worth of those cuts you have asked for would be substituted by suspension of the COLA, so we make up dollar-for-dollar that loss and we do not start cutting programs that are just going to get a furious reaction from people. In some of these programs, cuts would be counterproductive. But assume we suspend the COLA and we also reform entitlement programs, so that for the outyears we do not see this tremendous increase. We also have some real revenue enhancement measures, not speeded up collections from corporations or withholdling of dividends or whatnot. I do not know who thought that up. Do you really think we are going to pass that? But let us say we really do pass that, along with an oil import tax, and some other things of substance. Would that not be a stronger scenario than just putting forth what we have at this time?

Dr. WEIDENBAUM. One, if Congress enacts the whole proposal the President has submitted, that would have a positive effect on financial markets, because it shows we are biting those proverbial bullets. But if Congress, in its own wisdom, enacts a different set of cuts, consistent with the Nation's needs, that achieves the same or larger cuts in the deficit. I think, depending on the precise nature of those cuts, that too would have a positive effect on financial markets.

I spent much of last week in New York meeting with people in the financial community. The signal they want to receive is specific action that shows that the budget is under control and that those deficits, as we pull out of the recession, are going to be coming down.

Senator D'AMATO. That is why, Murray, some of the areas where the cuts are projected are not going to be successful. They are one term shots. They are not the kind of cuts that have cumulative effects. You need changes in existing legislation, and we are talking about entitlements again. We are talking about the military pensions that are sacrosanct, where you have a retired captain who retired 17 or 18 years ago as a naval captain, who receives more money today, higher pay today, than an active duty officer. It is similar in other areas.

Of course, if you say you want reform in the social security system, the next thing you know so-and-so says he wants to cut benefits that people are presently receiving. We must do it without cutting benefits people are presently receiving, we must limit future increases. Those are the kind of things that must be done and they will take some political courage. I suggest that this is the kind of dialog that Wall Street and the financial community is looking for. They are not looking for us to make a pittance cut, knocking out the urban development action grants to save $500 million. So what? Not when you are staring at a $150 billion deficit for fiscal 1983.

The other thing is, you come in and say $91.5 billion, and now it is up a little higher. People know and look at it who are not people looking to create a political controversy. They say the bottom line is, we are staring a deficit in the face that is much greater. That creates instability. That creates a situation where people lose confidence, and that is the problem. That is why I was so upset with your budget, not so much in terms of the goals. I am for the goal of reducing Government spending. But you cannot go to the public and to the media with this. You know, we have enough of a problem with credibility. You say we have a budget deficit that is $91.5 billion, but we know that the deficit is considerably more: $125 or $130 billion. We are going to have a real credibility problem. When, if we do have a program that is in place, will we have one that will operate?

I think that we are very close to being able to turn things around in a positive direction. I really do, but it will take some courage. It will take some action. But if you say, "If you just give me what I have asked you for now, that is going to be a very positive situation," that is not credible. I think Wall Street will not respond favorably to that. I do not think the marketplace will respond positively. I do not think interest rates will come down. I am not even worried about homebuilders as such. They have problems, but what about people who cannot sell a home or resell it. I think that it is an incredible situation that we have.

Well, I have given you my thoughts, and I would say to you that I would look for you to be more forthcoming, as you have been today. I think it is important that those people who made big sacrifices, such as yourself, who do not do this for money, who are knowledgeable, have a duty and an obligation to carry the message very clearly to our President as to the problems and the challenges and the opportunities we face.

I still think there is a great opportunity to turn this economy around, if we really show by way of legislation that we are going to act in a bipartisan manner, that we are going to address those projected huge deficits. I think, as you said before, if we show people that we can get the trendline down for future deficits, we can begin to establish a healthy long term bond market. When we begin to bring interest rates down, and when we reestablish the long term bond market, we can have an economic resurgence.

If we just talk about it and keep shifting blame, who has not acted and who has acted, that will be perceived exactly as it should be: That we are indecisive and that we lack the ability and the courage to go forward.

Dr. WEIDENBAUM. I find that a very heartening statement, Senator. Let me just add that in my view, getting the budget really under control means not just focusing on one or two key areas but developing truly a comprehensive program. I do not think that over the next several years we are really going to see those deficits come down as substantially as we need to, unless action is taken on a variety of fronts affecting many agencies, many parts of that budget, on both the expenditure and the revenue service.

Senator D'AMATO. Thank you very much.

We have a vote underway, but we have also waiting to testify a former New Yorker who is doing an excellent job, Frank Swain, who is Chief Counsel for Advocacy for the Small Business Administration.

Frank, you can start right now. In about 2 minutes that buzzer is going to go off. I am going to let you continue, and I will come back and ask you some questions.

STATEMENT OF HON. FRANK S. SWAIN, CHIEF COUNSEL FOR ADVOCACY, U.S. SMALL BUSINESS ADMINISTRATION

Mr. SWAIN. Senator, the subject of the hearing is the state of small business report, as well as the current economic situation, and my statement attempts to address both from the perspective of small business.

Let me first of all make some remarks about the state of small business report which is mandated by Public Law 96-302. Although Congress passed Public Law 96-302 in 1980, there was no report written in 1981. This is the first one. It was prepared largely by my office. I will be the first to say that it is not perfect in every regard.

Senator D'AMATO. Let me interrupt you for one moment. You may continue your testimony. I am going to vote and be right back.

Mr. SWAIN. Thank you very much.

I would be the first to say that it is not perfect or complete in every regard, but we did try to marshal all the information we had available that was relevant. The purpose of the report is to try to get on the record a measured amount of information concerning small business and to try to impress upon the administration, whatever administration, and the Congress, that small business is an important part of the American economy and deserves just as serious consideration in the budget process and economic policy process as any other part of the American economy.

Because of the scope and complexity of many of the facts in the report, it is easy to lose sight of some of the major findings within it. Small business, as is clearly demonstrated in the report, is not a homogenous entity. But there are several general statements that can be made.

First of all, consider the small business share of the gross national product. You find that in all major industry sectors, from 1967 through 1976, which is the most recent year for which we have been able to derive information, the decline in the private gross national product was about 3 percent, declining from 42 to 39 percent.

In particular, there was an across-the-board decline in the sales share of firms with less than 20 employees. In other words, the smallest of the small businesses are declining.

There was an overall decline in the number of small businesses with less than four employees. Declines were significant especially in the areas of retail and wholesale trade. I think that is interesting because, although the other areas showed simply a decline in growth in businesses with fewer than four employees, there was an absolute decline, even though the economy grew as a whole over that time period.

Finally, based on Internal Revenue statistics, the number of small businesses, including the number of sole proprietors, partnerships, and corporations, increased throughout the period.

There is one important anomaly in the numbers. While the number of small businesses overall is increasing, the number of businesses with fewer than four employees declined slightly. This decline could be attributed to scale economies associated with improved methods and technology, but a significant portion of it also appears to be due to the effects of regulation. In other words, businesses with one, two, three, or four employees just have a lot tougher time surviving than they used to.

Macroeconomic factors affecting small businesses, including the effects of inflation and fiscal and monetary policy, are discussed extensively in the report. I would like to spend just a minute talking about inflation, because personally I have been struck with the number of small business owners that I have talked to that genuinely greeted with great satisfaction the decline in inflation.

I think small business owners probably understand inflation more than I do as a Government official and more than many of the people that I work with. What I am hearing is that the problem they suffered with inflation was that inflation raised the cost of goods sold, and this forced them into the short-term credit market. They were not able to continue to finance their costs through retained earnings, and therefore it not only cut into their profit margins but they had to borrow more than they had to before. In fact, I think that evidence suggests that in the midseventies, when inflation was the worst, we started to see the major increase in the demand for short-term credit. At any rate, I think that the slowing of inflation has been a very important development for the small business sector, and certainly a lot of small businesses, as I mentioned, have greeted it with great enthusiasm.

Another very interesting finding, especially given the current recession, is that small business tends to be an economic buffer during recessions. Of course, we cannot really measure what is going on now as much as we would like to, so we took a particularly close look at our last experience in the 1974 recession and the 1975 recovery. What we found was that despite the fact that the return on the dollar of sales in small businesses went down through that economic decline, they were generally able to maintain employment at a much better rate than larger firms.

What that means is, I think, confirmed by businesses that we all know or are acquainted with. People tend to try to hold on to their employees in small firms, if they are at all able to, even though they may suffer a very bad effect on the profit line. They do not make what an economist might call the rational economic decision to close something down or slow something down in order to maintain their profits. I think this was an important factor in the last

recession and I would be very surprised if the evidence did not show that small business employment, and in fact small business formation, continue to be very strong throughout a recession, although profitability slacked off considerably.

I was asked by the committee to provide a statement on my view as to the current state of the economy. Let me place that statement in the context of the findings which I have just described.

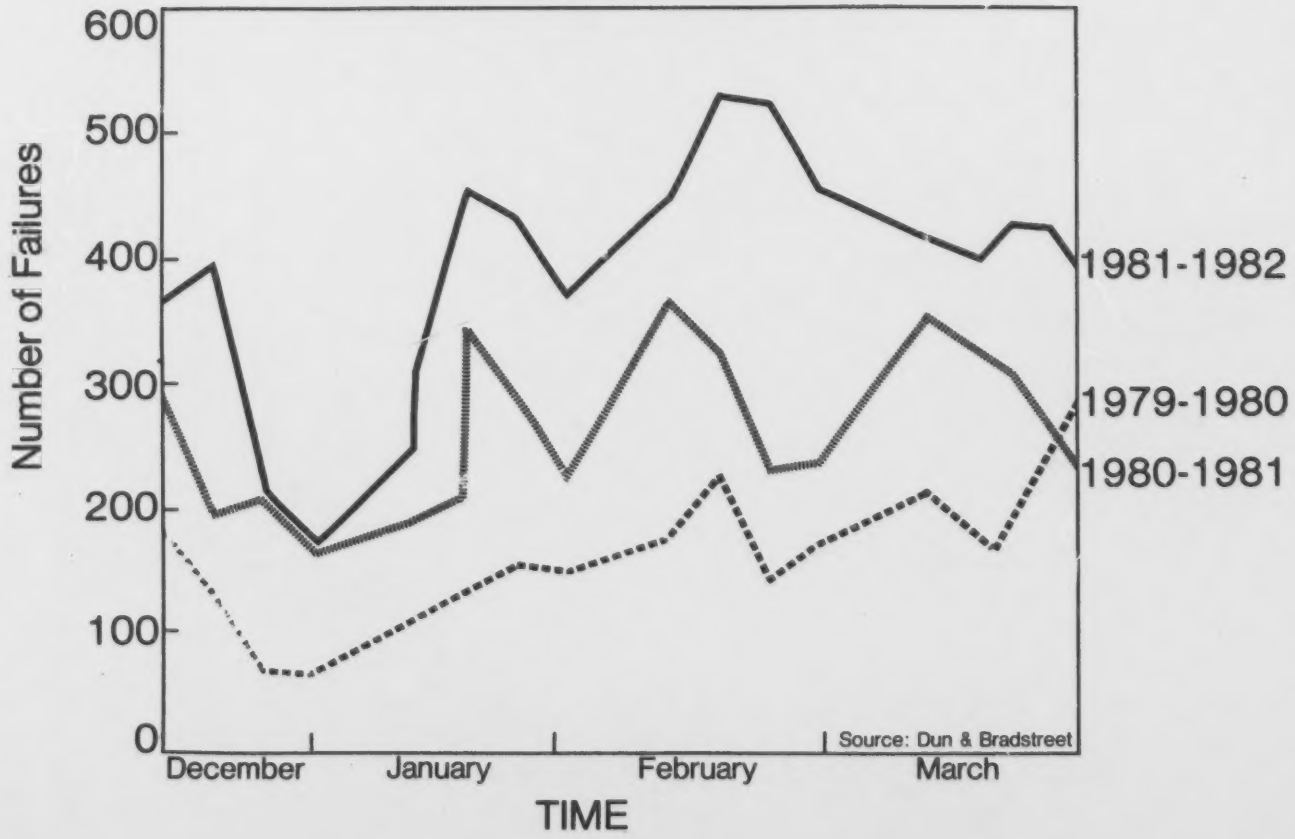
The major findings of the report are that a typical small business is getting smaller, is more heavily in debt, and is likely to maintain employment during periods of recession at the expense of profits. How does that relate to the current situation? Well, as Dr. Weidenbaum said in ways more magnificent than I could, we are certainly in a recession now, and it is having a big impact on small firms. Small business profits are down because we are near the bottom of the recession. Small business profits are down because high interest costs and increasing debt have eradicated profits. And small business capacity to sustain itself over a long period of recession is down because the average firm is smaller in real terms.

It just makes commonsense, yet it is something that we spend a lot of time talking about to people in the administration. Small firms go out of business because they do not have any choice. They cannot cut back their activities. There is a certain level beyond which they do not have any flexibility, and they are either here or they are not here. That is not the case with larger firms, where there is a good deal more flexibility to trim operations.

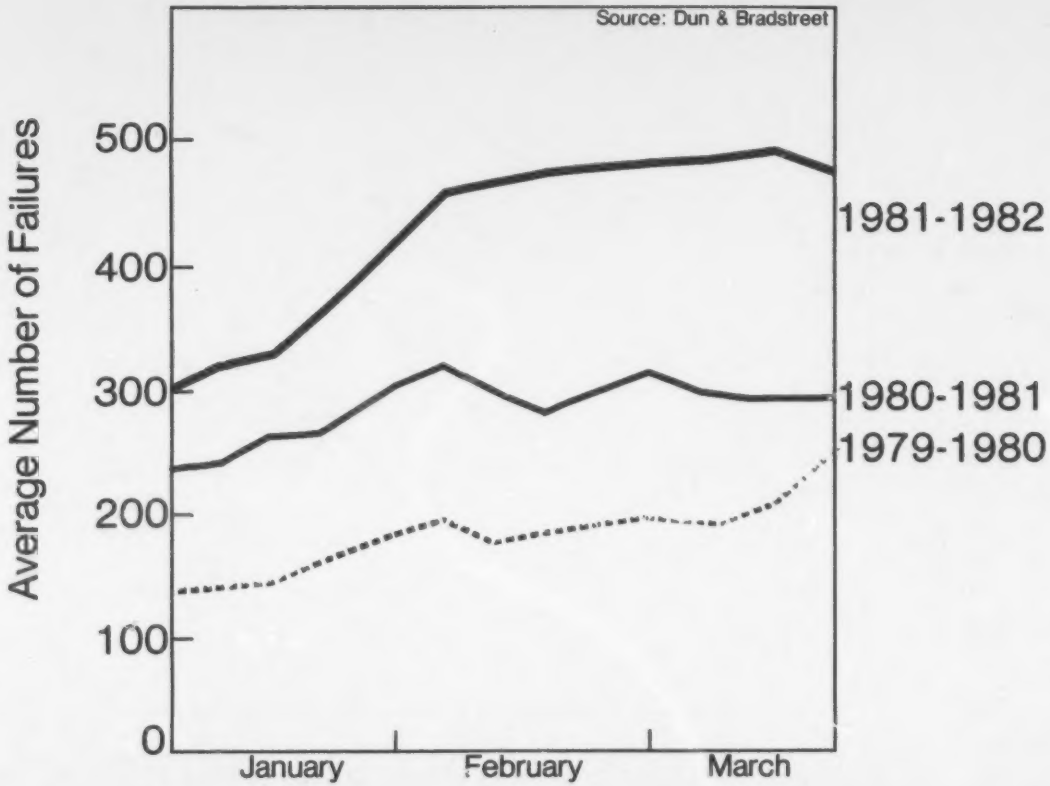
There are obviously a lot of measures of economic activity. There has been a lot of discussion of bankruptcy and business failure statistics, and I thought it would be helpful to the committee to set those in some sort of context. On page 8 of my statement there is an illustration, and I have brought some charts here as well. I would like to draw those to the attention of the committee. If it is all right, I would like them included in the record.

[Material follows:]

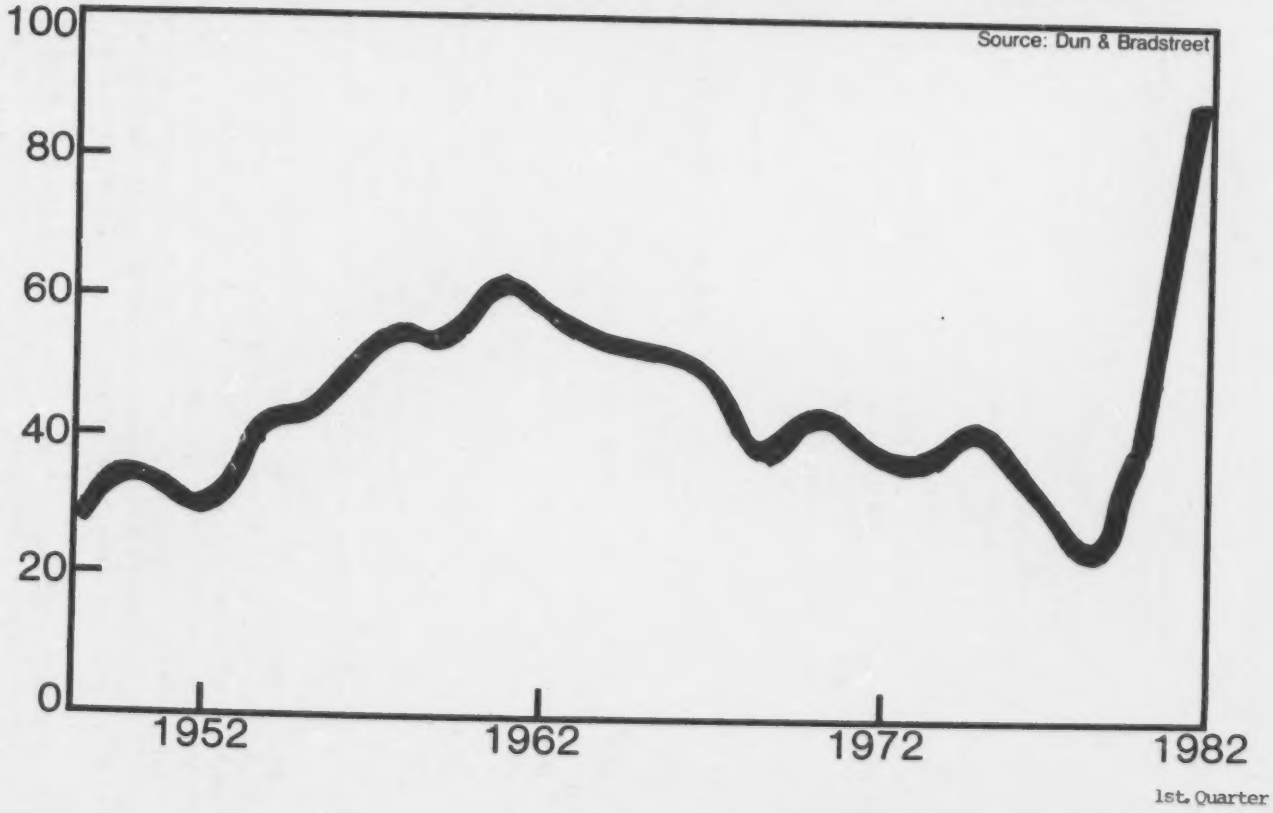
Business Failures



Average Business Failures



Failure Rates Over Time Per 10,000



Mr. SWAIN. That first chart depicts business failures over time, by tracking the 4 months of December, January, February, and March, for 1979–80, 1980–81, and 1981–82. As you can see, the cycle is fairly consistent. People do not go out of business before Christmas, but failures generally tend to increase in January, February, and March. The numbers do show that the trend of business failures is shifting up. The level of business failures for 1980–81 is up about 55 percent over the 1979–80 figures. For 1981-82, the level is up about another 48 percent over the 1980–81 figures.

This second chart shows the same thing but we have smoothed the data using a 5-week moving average. The fact that we are seeing a lot of businesses go under now is not particularly surprising, given the time of year, but the fact is that we are in a quantum leap above where we were in 1979–80 and 1980–81. We have noticed that in the last 2 weeks in March, the figures tend to be flattening out, if not dropping slightly. I am not an economist, and I will not predict anything about the future of the economy, but it does seem that we are at a flat period. Over the last 3 months, or rather over the last 2 months, things did not get any worse. Whether they get better or not, I will leave to people more intelligent about this sort of thing than I am.

The third graph is an attempt to measure not absolute numbers of business failures but business failures per 10,000 firms. There is basically a 30-year record on that graph. Business failures are measured through the Dun & Bradstreet index, which is based on a review of approximately 3 million firms. As you can see business failures were high in the 1961 recession and they have just shot up off the graph almost in the last year. As to what they are going to do in the period to come, I could not tell you, but it is clear that we are undergoing a recession now. In severity, at least as far as small firms are concerned, it is probably as severe a recession as we have had. In terms of the economy or other measures as a whole, I cannot argue with Dr. Weidenbaum or the Senator as to whether this is absolutely the worst recession, but small business clearly knows that it is the worst.

Let me add one thing on those figures, because we have spent a lot of time arguing about them within our office. These are all based on Dun & Bradstreet figures. Dun & Bradstreet, just as anyone else in the country, does not know where every business is or what every business does. Their figures represent a sample and not a complete survey of business failures. Also, the figures lag, inevitably because there are delays in filing for bankruptcy, or in other legal actions. So what we are seeing are reports now that may actually represent events that have happened anywhere from 1 to 6 months ago. Certainly, the recession continues to get worse, but it may be flattening out now, as the figures indicate.

The bankruptcy figures are less reliable, in the sense that the law changed dramatically in October 1979, and they really do lag even much more than the Dun & Bradstreet figures.

What can we do to improve the situation for small business? Well, small business is in serious trouble because of inflation, high interest rates, and a continuing recession. As I mentioned before, inflation clearly is slowing and nearly every small business owner I

have talked with believes that this is an important and overdue economic development.

High interest rates are seen by many as a key factor. Current monetary policy has been in effect more or less since October 1979. In the past 30 months, neither the Carter nor the Reagan administration nor the Congress has seriously disagreed with the underlying Federal Reserve Board policy of measured monetary growth. Indeed, the financial markets now cough immediately upon the suggestion of criticism of the Federal Reserve over its basic policy.

Small businesses complain to me as much about the volatility of interest rates as they do about their absolute level. I cannot tell you how many small businesses I have had say, "We know that rates have to be high for a while because we are going through this economic change, but why can't they at least be a little steadier?" I had a number of people tell me, back in November when the rates went down for a short time, that it did not make one bit of difference to small firms. Small business owners are going to banks, and they are trying to factor inventory that they are going to have to pay for over the next 6 to 12 months. However, until the financial community sees some sort of continuing trend in interest rates—you know, as Mr. Weidenbaum said, apparently interest rates never move in a straight line—they are not going to really change their conduct as it relates to small firm borrowing.

Small businesses, I think, are really burdened much more than larger firms that have other sources of credit, equity, lines of credit, and so on, when the Federal Reserve Board goes all over the mark in its week-to-week or month-to-month record. Not only does the credit market for small firms not respond to changes, but any major changes in money growth have recently elicited immediate rate increases by the major players in the financial community in anticipation of a resurgence in inflation. This is why, despite a strong immediate concern over high interest rates, it just does not appear that any sort of basic or dramatic shift by the Federal Reserve Board is a viable way out of the current situation. If the Fed were to change its mind and start doing something else, I think the financial community would recoil so much that it really would not accomplish anything at all.

This does not rule out, however, discussing ways to keep Federal Reserve practices more on target over time. Again, there is criticism about specific practices and procedures at the Federal Reserve Board. That is not what we are expert at, but we think there has to be a greater degree of predictability, and there certainly has to be a long-term trend downward.

Let me speak a moment about wage and price controls, because that is occasionally mentioned as seemingly the only solution to our current economic situation. I do not think that it is, and I do not think small business thinks it is. Wage and price controls are bureaucratic, not very workable, and a tremendous burden on small firms. The administration has made a valiant attempt to free up the American economy from rigid and artificial Government constraints, and I believe it would be inappropriate to move back to them.

Other factors affecting the current situation of small business must be seen in the context of the steps already taken by the ad-

ministration to improve the situation. Both the President and the Congress in passing the Economic Recovery Tax Act of 1981 agreed that major tax relief was an important ingredient affecting the psychological outlook of both large and small business and consumers. The full intent of this act was to provide some degree of certainty to consumers that their incomes would be protected from continually escalating taxes and to provide business with a flow of funds sufficient to increase investment and productive capital.

We believe that the key to success of the legislation is that it effectively change expectations about the future. I think it is headed in that direction, and also headed in that direction were the cuts made in the fiscal year 1982 budget at the request of the President last year. However, any improvement in expectations which occurred last year appears to have been more than offset by the size of the deficit projected in fiscal year 1983. The increasing confidence experienced by businesses in 1981 has been eroded by the continuing recession in 1982 and appears to have been decimated by fears that the Federal demand for funds to finance the deficit are going to crowd out the market for private sector and particularly small business credit. I think that most small businesses and most large businesses believe it will be difficult for the Government to obtain funds at reasonable prices in fiscal year 1983 and in later years.

My recommendation to this committee, then, is that the committee and your colleagues in the Senate take some steps to lower the anticipated deficit, for fiscal years 1983 and 1984. I realize this may be a commonplace recommendation, one that you hear quite frequently, but I also realize that accomplishing it may be an extremely difficult task for you. None of the options open is very pleasant. I believe it is appropriate to state, as a representative of small business, that there is still great sympathy in the small business community for further reductions in Federal expenditures, and I believe that such reductions would be an important contribution to the process of reducing the deficit.

Let me say one thing about the recent tax changes. The more I talk to small business people, the more I am convinced that the thing that really makes a difference for them is the cut in the individual tax rates. I have talked to any number of small business people who say, "That's the big deal." So I would caution against any proposals to repeal or delay the scheduled cuts in the individual tax rates. That is the thing that puts money into the hands of people who have sole proprietorships and partnerships and into the hands of consumers who often do business with these small retail stores that are having such a difficult time currently.

My message is that the anticipated deficit for the Federal Government in 1983 is so large that fears related to it are clearly interfering with the efficient conduct of the Nation's business. This is basically what you said in your conversation with Mr. Weidenbaum, Senator. As interesting as it might be to lay out a series of special programs and little things we could do for small firms, the honest truth is that small firms are not going to respond until the economy responds, and the way to get the economy to respond is to get rid of the psychology that the Federal Government cannot live within its means. Maybe the Federal Government will not balance

the budget every year, but we have to do better than it looks like we are going to do in the next 2 or 3 years. I think that if the Congress and the administration were able to get the budget more under control, the financial markets would in fact respond. We would have better credit conditions for large and small firms alike. That is the most important thing that can be done right now.

I would be happy to take any questions you might have.

[Material follows:]

STATEMENT OF THE

HONORABLE FRANK S. SWAIN

CHIEF COUNSEL FOR ADVOCACY

SMALL BUSINESS ADMINISTRATION

BEFORE THE COMMITTEE ON SMALL BUSINESS

U.S. SENATE

MARCH 31, 1982

Mr. Chairman and members of the Committee, I am pleased to have this opportunity to appear before you to discuss the current state of small business and to provide you with some comments on the recent report The State of Small Business, submitted to you by the President. In the course of my testimony I would also like to briefly comment on current economic policies as they relate to the welfare of small business, and in particular as they relate to the goals established in Public Law 96-302 regarding small business and competition.

Comments on the Report

I believe that the report on the status of small business and competition as submitted by the President represents a good effort on the part of the Administration to fully examine the current status of small business and provide a useful summary of our current knowledge of small business. The report contains a myriad of statistics, many of which are generated for the first time and many of which are derived from the external data base developed by SBA. I believe the overall report is factual, and relatively complete, given the state of our current knowledge.

The report clearly indicates where there are significant shortcomings in the data available to us to describe the situation of small business. It also provides a discussion of the completeness and usefulness of current Federal statistics relating to business. The report certainly shows the wisdom of this Committee, which has been a prime mover in the drive to build an external data base more adequately describing small business. The fruits of our initial efforts to comply with your direction are sprinkled throughout this report.

Much of the material in the report was prepared by my staff, working closely with the staff of the Council of Economic Advisors, and the language reflects that it was to be transmitted to you by the President. As I have stated, the report, I believe, is completely factual, some would even argue too factual, but the authors occassionally do not draw conclusions as clearly as the facts might warrant. I will attempt to clarify some of the conclusions briefly in a few moments. As with any major Presidential report, all of the major departments were offered numerous chances to comment and to provide additional material. As a result, the language of the report is sometimes less forceful than it would have been if it had been an Advocacy document. I should stress to the members of the Committee that I do not believe this criticism

to be a major fault but simply one which should be noted for the record. The authors appear to have been scrupulously honest in laying out the many facts which best describe the current state of small business and competition.

Because of the scope and complexity of many of the facts of the report it is easy to lose sight of the major findings within the report. Small business, as is clearly demonstrated in the report, is not a homogeneous entity. On the contrary the heterogeneous nature of small business almost overwhelms our ability to simply describe the current state of business in this economy. I do believe that several general statements can be made however.

1. The small business share of sales declined from 56.0% in 1972 to 51.3% in 1977. The small business share of GNP declined from 42% in 1967 to 39% in 1976.

2. In particular there was an across the board decline in the sales share of firms with less than 20 employees.

3. There was an overall decline in the number of small businesses with less than four employees. Declines were significant in the areas of retail and wholesale trade.

4. Based on Internal Revenue Service statistics the number of small businesses including the number of sole proprietors, the number of partnerships, and the number of corporations increased throughout this period.

With more small businesses accounting for a static or smaller share of GNP, the relative receipts of the average small business are declining compared to larger businesses. Another way to express this is to say that sales per worker are down for the typical small business. This would certainly increase the vulnerability of the average small business during periods of recession.

There is one important anomaly in the numbers that I have just discussed. While the number of small businesses overall is increasing, the number of businesses with fewer than four employees declined slightly. This decline may be attributed to scale economies associated with improved methods and technology but a significant portion of it also appears to be due to the effects of regulation. The extent to which small businesses have been regulated has meant that the typical small business must become larger in order to deal with regulation effectively.

Macroeconomic factors affecting small business, including the effects of inflation and of fiscal and monetary policy are also discussed extensively in the report. The effects of inflation are vividly described in the following quotation from the report.

> "Inflation increases the dollar value of sales without being accompanied by a growth in the volume of sales. Larger sales require larger accounts receivable and larger inventories. This increases the need for additional cash inflow, either from more retained earnings,

> from additional equity investment, or from more borrowing. Ideally, if profits increase proportionately relative to increases in accounts receivable, inventories, and liabilities, the debt ratios for the concern should not deteriorate.
>
> In reality, business profits, and consequently, retained earnings, lag behind the increases in other items. Since an increase in dollar value of various asset items is not matched by increased retained earnings, additional indebtedness is incurred by businesses to finance the increase. Consequently, the debt-equity ratio of the firm deteriorates."

The increase in the debt-equity ratio over time in response to continued inflation clearly places smaller firms in a potentially more dangerous position in a recessionary economy. Even in a non-recessionary period, a small business faced with an increase in interest rates may face a cash flow crisis. In a recessionary period where sales are dropping small businesses will clearly be in a dangerous position as sales and total receipts drop but interest rates remain high due to a lag in inflationary expectations or due to an active monetary policy designed to counteract inflationary expectations. During the past several years both inflationary expectations and monetary policy have combined to maintain higher than normal interest rates and small businesses have been placed under a continually greater strain as their relative debt loads increased. The increases in interest payments brought about by increasing debt came almost completely from the profit line of a typical small business income statement.

Another major finding coming from the report is that small businesses exhibit unusual behavior during recessionary periods. What was found in reviewing the 1974 recession was that small businesses appear to maintain employment even at the bottom of a recession, and adjust to decreased demand for goods and services by lowering output and accepting greatly reduced profits. This fact has important social ramifications, reflecting the role of small business as a "shock absorber" cushioning the full effect of recession on employment in the economy.

The Current State of the Economy

I have been asked by the Committee to provide a statement on my view as to the current state of the economy. Let me place that statement in the context of the findings which I have just described. The major findings of the report are that the typical small business is getting smaller, is more heavily in debt, and is likely to maintain employment during periods of recession, at the expense of profits. How does that relate to the current situation?

I believe that the current economy can be described as in the midst of a typical recession, still experiencing relatively high interest rates compared to past norms, and compared to what we would expect at the bottom of a recession and in a period of declining inflation. In addition, we have had two periods within the last two years officially described as

recessions by the National Bureau of Economic Research and we are currently in the second quarter of a third recession which appears to be much deeper than we had originally anticipated.' If our review of facts relating to past recessions and the past behavior of small business are any indicator, we must conclude that small business profits are down because we are near the bottom of a recession; small business profits are down because high interest cost and increasing debt have eradicated profits; and small business capacity to sustain itself over a long period of recession is down because the average firm is smaller in real terms. The conclusion is inescapable: the economy is in trouble and small business is in worse trouble.

There are obviously many measures of economic activity, but one which always receives public attention is business failures and bankruptcies. My office carefully monitors whatever information we can gather with respect to the survivability of small business. We watch bankruptcy statistics on a monthly basis and business failure statistics on a weekly basis. We have been tracking these statistics carefully for the last three years. Business bankruptcies showed a major increase following the revision of the bankruptcy law in 1979. Since that time, business bankruptcies appear to have increased approximately 30 percent from the base level established following the change in the law. Bankruptcy statistics for the first month of 1982 reflect relatively little change in trend.

Business failure statistics show a large increase for the months of January, February and March, 1982.1/ The business failure numbers show an increase in total failures for the three month period of about 56 percent from 1980 to 1981 and about 48 percent from 1981 to 1982.

	79/80	80/81	81/82
Average number of bankruptcies (Dec., Jan., and Feb., except 81/82 which is Dec. and Jan.)	2716	3794	4078
Change in average number of bankruptcies		+40%	+7.5%
Number of business failures recorded by D&B for 13 week period ending during 1st week of March	2070	3477	5095
Percentage change		+64.7%	+46.7%

1/ Bankruptcy figures from the Administrative Office of U.S. Court business failure data is from Dun and Bradstreet's regular trading of 2.8 million firms.

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I certainly caution reading more into these statistics than is appropriate given the short time since the shifting in the trend line and the time and sample limits of Dun and Bradstreet. But no one should be suprised that the shift has occurred. Every thing that we know about the basic behavior of small businesses in a recessionary world and in a world of high real interest costs indicate that the number of failures should be increasing relatively dramatically during this third recession in three years.

Improving the Situation for Small Business.

Small business is in serious trouble because of inflation, high interest rates and continuing recessions. What can be done to remedy this situation?

Inflation clearly is slowing and nearly every small business owner I have talked with believes that this is an important and overdue economic development.

High interest rates are seem by many as the key. The current monetary policy has been in effect more or less since October, 1979. In the past thirty months, neither the Carter nor Reagan Administration nor the Congress has seriously disagreed with the underlying Federal Reserve Board policy of measured monetary growth. Indeed, the financial markets now cough immediately upon the suggestion of criticism of the Federal Reserve over its basic policy.

Small businesses complain to me as much about the volatility of interest rates as they do about the high levels of rates and here, I believe, criticism of the Federal Reserve Board is warranted. It does a small business seeking credit no good for rates to come down for a period of weeks or months. Not only are decisions on marketing and production made currently for months ahead of time, but the bank or factor is unlikely to reflect a lower rate unless there is confidence that it will stay low. I have talked with too many small business owners who tell me the November drop in rates was ignored by their factors and bankers because of a lack of confidence in what would follow.

Not only does the credit market for small firms not respond to changes, but any major changes in money growth have recently elicited immediate rate increases by the major players in the financial community in anticipation of a resurgence in inflation. This is why, despite a strong immediate concern over high interest rates, It does not appear that a basic shift in Fed policy is a viable way out of the current situation.

This should not rule out however, any recommendation on how to keep the Federal Reserve practices more on target over time. Some suggest that the Government impose controls on wages and prices. Such controls have been mentioned by some members of Congress but I believe there is very little sympathy towards such a solution. Our best experience has shown that such

controls are overly bureaucratic and unworkable over time. The Administration has made a valiant attempt to free up the American economy from rigid and artificial government constraints and I believe it would be inappropriate to move to them.

Other factors affecting the current situation of small business must be seen in the context of the steps already taken by the Administration to improve the situation. Both the President and the Congress in passing the Economic Recovery Tax Act of 1981 agreed that major tax relief was an important ingredient affecting the psychological outlook of both large and small business and of consumers. The full intent of this Act was to provide some degree of certainty to consumers that their incomes would be protected to some extent from continually escalating taxes, and to provide business with a flow of funds sufficient to increase investment in productive capital. The key to the success of the legislation in my opinion, is that it effectively change expectations about the future. The recent cuts in the Federal FY 1982 budget, as approved by the Congress at the request of the President, were also intended to have a positive psychological effect on both business and on consumers. Both the tax act and the budget cuts were well received.

Any improvement in expectations which occurred last year, however, appears to have been more than offset by the size of the deficit projected in the FY 1983 budget. The increase in confidence experienced by business in 1981 has been eroded by the continuing recession in 1982 and appears to have been

decimated by fears that Federal demands for funds to finance the deficit will overwhelm the capability of the capital market to supply those funds at reasonable prices. Business appears to see a future in which the economy remains comparatively stagnant, and where interest rates remain high as the Federal Government continues to compete for large amounts of funds to finance each increasing deficit. Recently released figures on real capital investment in 1981 and on projected real capital investment in 1982 indicate that business is holding off from most major investment plans. While it appears possible for the Federal Government to finance the 1982 deficit without pushing up interest rates, I believe that most small businesses and most large businesses believe it will be difficult for the government to obtain funds at reasonable prices in FY 1983 and in later years. As long as this belief exists, business will not take the actions necessary to help the economy increase productivity and expand output to meet increasing consumer and producer demands. My recommendation to you, therefore, is that you and your colleagues in the Senate take some steps to lower the anticipated deficit facing the economy in 1983 and in 1984.

I realize that this may be a common place recommendation, one that you hear quite frequently these days. I also realize that accomplishing it may be an extremely difficult task for you to face. None of the options open to you in terms of reducing Government expenditures, whether reducing expenditures in defense, in entitlement programs, or for other social programs is an easy one; neither is the option on the other side of increasing taxes to lower the deficit.

It is not my place to recommend expenditure changes to the Committee; the dialogue on expenditure issues should be carried out through the regular budget process between the Congress and the Executive. I believe that is appropriate to state as a representative of small business that there is still great sympathy in the small business community for further reductions in Federal expenditures. I believe that such reductions would be an important contribution to the process of reducing the deficit.

With respect to changes in taxes, I think it extremely important that the personal income tax cuts put in place by the Economic Recovery Tax Act not be changed. These personal tax decreases are important to small business people, because so many of them operate as sole proprietors or partners, and they are also important because of the perception among small business people that the income tax reduction will increase disposable income and consumer spending. If tax changes are to be made I believe that the Congress should investigate the special provisions in the tax law which lead to so called "tax expenditures". A thorough Congressional examination of all special tax provisions is a minimal price for business to pay after the very dramatic and beneficial changes approved last year.

My message is that the anticipated deficit for the Federal Government in FY 1983 is so large that fears related to it are clearly interfering with the efficient conduct of the nation's business. The Congress should consider changes in

expenditures and changes in tax receipts as methods for reducing the deficit to a more acceptable size. The best thing the government can do for small business right now is to restore the expectation that the government will live more within its means. I believe that the small business community would enthusiastically respond.

Mr. Chairman there are a number of specific issues outlined in the report of concern to small business. I am happy to respond with further comments to any questions.

THE STATE OF SMALL BUSINESS

Executive Summary

Public Law 96-302 requires the President to report annually on the state of small business and competition. The State of Small Business is the first report under that mandate and includes the Small Business Administration's (SBA) Annual Report on Small Business and Competition. The SBA report concentrates on setting out the most recent and relevant evidence describing small businesses, including how many there are, where they are, and who owns them. It describes changes in the economy and the small business sector, and details the impact of Federal policy on small business.

Small businesses account for 38 percent of the nation's Gross National Product (GNP), contribute two out of three new jobs, and produce twice as many innovations per employee as larger firms. This historical vitality, however, has been severely tested in recent years by several major factors:

A larger number of small businesses are contributing to a declining share of GNP;

Bankrupticies and business failures have risen almost 30 percent in the last two years;

Inflation of the past decade has made it difficult for small firms to replace assets and to continue to hold inventories without excessive borrowing; and

High interest rates have exacerbated the risks in borrowing.

The economic health of the small business sector has been sorely tested due to factors over which small business owners have little or no control. However, with the continuing slowdown in inflation, small firms should be able to return to a more profitable and long-term growth position.

Chapter I of the SBA report attempts to show how small business is often defined, how small firms are counted, and how they are distributed by industry and location. The chapter also includes a comparison of the major sources of comprehensive business information in the United States.

Chapter II presents current information about changes in the small business sector, including discussions of growth and decline, profit and loss, and changes in the relative share of output attributable to small business. The discussion reflects changes in dynamic phenomena over time, and includes a section on the experience of small business during the 1974-76 recession. Chapter II also examines longer term trends in employment and sales in the small business sector from 1955-1977, with particular emphasis on the declining small business share of the GNP. The chapter includes a discussion of employment trends by industry and size class in the small business sector at the state level from 1977-1979.

Chapter III discusses the major macroeconomic forces that affect the small business sector. It includes a section on the effects of rising inflation and interest rates on the financial condition of the small business sector, and discusses the trends in profit rates and in increased borrowing by small businesses. The chapter also examines the impact of business cycles in general on small business and observes changes in business failures,

employment, and sales and profits during a recession. Chapter III outlines the implications of the changing financial markets for small business financing, such as the increasing conglomeration of the financial service industry as a result of deregulation, the increasing use of the variable-rate loan arrangement, and the impact of a large Federal deficit.

Chapter IV is a discussion of the effect of Federal policy on small business, and includes a section on access of small business to capital and credit sources and how this access is influenced by banking regulations, securities and tax laws, and venture capital policy. The chapter includes a discussion of government regulatory reform policy and examines specific policies affecting small business. The chapter also examines the competitive climate for small business and highlights specific small business concerns.

Additionally, the report contains an appendix of tables and charts which illustrate the state of small business. Other appendices detail data collection efforts, describe progress being made by minority-owned and women-owned businesses, analyze the impact of tax and securities laws on small business, and provide information on Federal agency small business offices.

The following pages of this executive summary highlight major issues discussed in the report by chapter.

CHAPTER I. SMALL BUSINESS IN THE U.S. ECONOMY

Defining Small Business

- There are 10,000 large companies in the United States with 500 or more employees which do business at 415,000 separate business units (establishments). The remaining 99.8 percent of the businesses in the country may be called small.

  The small firms employ 47 percent of the non-government labor force.

  The 10,000 large firms employ 53 percent of the non-government labor force.

  The small firms produce 38 percent of the nation's GNP.

  The large firms produce 62 percent of the nation's GNP.

Proprietorships, Partnerships, or Corporations

- There were 14.7 million businesses that filed tax returns with the Internal Revenue Service in 1977 (latest year for which detailed data is available).

  11.3 million proprietorships
  2.2 million corporations
  1.2 million partnerships

Data Collection

- Major data collection problems continue to frustrate the ability to measure the small business sector.

  Detailed statistics are available from the Census Bureau on 5.6 million of the 14.7 million businesses in the United States.

  The remaining 9.1 million businesses have little statistical information collected on them, with the exception of an annual tax return. Half of these businesses report annual incomes of less than $10,000.

  The number of full-time active businesses in the United States is around 7.0 million.

  5.6 million are covered in the Census Bureau's Enterprise Statistics (but only in 6 of 8 major industries).

  3.7 million are covered in the Small Business Data Base (in all major industries).

  The remainder are known primarily through telephone listings in the yellow or white pages.

The Distinction Between Establishments and Enterprises

- Enterprises are businesses that are separately owned and operated. An establishment is the smallest unit in which business activity is conducted. Establishments may be branches of larger enterprises.

  About 15 percent of total employment (15 million workers) are employed in small establishments owned by large companies.

  Programs designed to help small firms are sometimes used by branches of large companies, contrary to the programs' intent.

  Data by ownership status is needed to understand and study market concentration at the local level.

Minority-Owned and Women-Owned Businesses

- The number of businesses and share of total receipts have increased in recent years for both minority-owned and women-owned firms.

  Minority-owned firms account for approximately 5.7 percent of total businesses and 3.5 percent of total gross receipts. This represents an increase of 31 percent in the number of firms and an increase of 69 percent in gross receipts from 1972 to 1977.

  Women-owned firms account for approximately 7.1 percent of total businesses and 6.6 percent of total gross receipts. This represents an increase of 30 percent in the number of firms and an increase of 72 percent in gross receipts from 1972 to 1977.

Categories for Analyzing Small Businesses

- Small firms can be analyzed in terms of assets, sales or employment. However, employment data is more frequently collected and does not have to be adjusted for inflation. No government agency tabulates data on all three bases: assets, sales, and employment.

  IRS collects assets and sales data.

  Census collects employment and sales data.

  The Small Business Administration's Small Business Data Base tabulates data from commercially compiled files covering assets, sales and employment information.

Industry Concentration

- The traditional small business industries are agriculture, forestry and fishing, contract construction, wholesale trade, retail trade, and services.

In those industries, small firms with under 100 employees account for more than half of the receipts and half the employment within the industries.

An exception is in the services industry, where small firms have higher sales per employee than in large firms, but still account for less than half the sales and employment in the industry.

The small firm share of GNP declined in every industry from 1955 through 1976.

In the non-traditional small business industries (manufacturing, mining, finance), small firms account for 20 to 30 percent of jobs, and 10 to 20 percent of sales.

Geographic Concentration of Firms

- Retail trade, a traditional small business industry, is the most dispersed industry nationally. That is, the largest retail trade firms have about 180-200 branches distributed throughout the country.

  The other traditional small business industries are much more locally concentrated. By comparison, service firms, which are less dispersed, generally are single unit companies. Even the largest companies, with 1,000 or more employees, only have about 20 branches each.

Employment by State

- The growth of small firms is associated with rapidly growing states. In general those states with the fewest employees per company (Colorado, Alaska, Wyoming, Vermont) are also rapidly growing in industries such as:

  Leisure and health services (Vermont, Colorado); and

  Extractive and energy-related industries (Alaska, Wyoming).

Small Firm Performance

- The conventional definition of productivity, output per unit of input, usually places small firms at a disadvantage. This is so because:

  Physical output per unit of input (or value-added) is an inapplicable concept in traditional small business industries like services;

  Conventional definitions exclude the training of workers by small firms who then move on to large companies without compensation to the smaller firms; and

  Conventional definitions ignore major contributions of small firms to GNP such as the use of abandoned resources not desired by larger companies.

Innovation

- Small firms are generally two to two and one-half times as innovative per employee as larger firms.

  Small firms have higher sales per dollar of assets in most industries compared to larger firms because small firms are generally undercapitalized and have fewer assets per employee "to go around."

CHAPTER II. CURRENT AND HISTORICAL TRENDS IN THE SMALL BUSINESS SECTOR

Recent Changes in Employment and in the Number of Establishments, 1977-1979 (The most recent period for which comparisons can be made)

- From 1977-1979, the services industry grew fastest, contributing 2.1 million or 29.7 percent of the total increase in employment.

  The fastest-growing industries included educational services, social services, transportation services, business services and auto repair services.

  Small establishments under 100 employees contributed 55 percent of this total growth, about 5 percent above their total share.

  Although job generation by small firms continues to be dominant, the small firm share of GNP, even in services, continues to decline.

- From 1977-1979, the smallest establishments of 1-4 employees declined by 1.4 percent in almost every major industry, compared to their overall growth of 3.8 percent from 1975-77.

  The survival of businesses with under 5 employees is threatened, especially in retail trade which experienced a decline of 15 percent from 1977-79, and manufacturing, which experienced a decline of 13 percent from 1977-79.

- The vast majority of the decline of the smallest establishments is from involuntary dissolution, due principally to a larger scale of output required for successful competition.

Business Formation

- It is difficult to compare the various sources of business formation because of the non-comparability of their bases. However, the following observations can be made:

  According to IRS tax files, businesses continue to form at an annual historic rate of between 2 and 4 percent (higher for corporations, lower for proprietorships);

The Commerce Department's Index of Business Formation has declined from 135 in 1978 to 117 in 1981, (1967 = 100); and

Business data are made more difficult to interpret by recent rapid increases in the number of self-employed workers (contract cleaning services, child-care workers, and skilled construction contractors, among others).

Business Failure and Bankruptcies

- It is necessary to distinguish the difference between a business which ceases operations (about 85 percent of the total) and one which fails or declares bankruptcy (15 percent of the total):

  Business dissolution - the dissolving of a business for any reason (including retirement of the owner);

  Business failure - the cessation of business activity which may occurr with no reported loss to a creditor; and

  Business bankruptcy - the cessation of a business with reported loss to a creditor.

- Generally business dissolutions are about four times the number of reported bankruptcies and about 10 times the number of failures reported by Dun and Bradstreet, the major source of commercial credit information.

  There were 46,500 bankruptcies from September 1980 to September 1981.

  There were about 15,700 failures reported by Dun and Bradstreet in 1981.

IRS data indicate the largest recorded occurrences of partnership dissolutions for 1978 were in heavy construction (31 percent), furniture stores (19 percent), miscellaneous repair services (15 percent), and special trade contractors (18 percent). All of the above industries are dominated by small firms.

Trends in Bankruptcies and Failures, 1980-1981

- There has been a 32 percent increase in bankruptcies between 1980 and 1981 according to data from the U.S. Administrative Office of the Courts. However, the Bankruptcy Reform Act of 1978 has extended filing to proprietors, which may have inflated the data. Business failures reported by Dun and Bradstreet increased about 42 percent between 1980 and 1981.

  The increases in business failures (1980-1981) have been heaviest in small business industries: construction (49 percent); services (47 percent); retail trade (41 percent); and wholesale trade (32 percent).

- The larger the firm the better chance it has of surviving.

  A firm with 21-50 employees has a 54 percent chance of surviving four years. A firm of under 20 employees has a 37 percent chance of surviving four years.

  Younger firms that survive are the major job generators - one-half of new jobs created by expansion are in firms less than eight years old.

Recession and Small Business

- The effects of a recession on the small business sector may be classified according to output effects, profit effects, employment effects, and merger/consolidation effects.

  The effect on overall small firm output during a recession is mitigated by retail trade and service firms which are less sensitive to the business cycle than wholesale trade and construction firms. The latter industries are the most cyclically sensitive.

- The profit position of small firms is quite sensitive to business cycles and absorbs much of the impact of such cycles. During the 1974-76 recession:

  Profits fell in large firms but they fell faster and further in small firms; and

  When profits rose in large firms as the economy came out of the recession, they generally rose more slowly in small firms.

- In contrast to the effects of recession on small firm output and profit trends, recessions appear to have little effect on the share of small firm employment in the economy. This is because of offsetting trends:

  Small firms frequently cannot release employees during a recession and continue to sustain a viable business;

  The specific training invested in workers in small firms would be lost if workers were released; and

  Some workers released by larger companies appear to start their own businesses during recessions.

- During the 1972-76 period, small firms remaining independent had higher growth rates during the 1974-76 recessionary period than those which were purchased by larger firms. The implication is that newly merged firms may have a smaller rate of growth.

Longer-Term Employment and Sales Trends, 1958-1977

- The decline in sales share of companies with under 20 employees has accelerated in recent years: -4.5 percent from 1972-77, compared to -10 percent from 1958-77.

For all firms over 20 employees, the sales share has remained relatively stable.

Very small (zero employee) companies and companies of 1-19 employees have suffered the largest erosions of market shares.

- o There has been relative stability in the employment share of companies with under 500 employees for the last 20 years.

  The employment share of all small firms has changed by less than 1 percent between 1972-77.

  There have been offsetting changes in small firm employment shares: increases in the employment share of small firms in construction, manufacturing, finance, and declines in the small firm employment share of mining, agriculture, trade and services.

  Differences between employment shares and numbers of new jobs need to be carefully understood. For example, despite the employment increase in the services sector, the small firm employment share continues to decline.

  There has been less than a 2 percent decline in overall employment share from 1958-1977 (55-53 percent).

State Employment Growth, 1977-79

- o Rapidly growing states also experience rapid small firm growth:

  Leisure services have grown rapidly in Florida, and energy related industries have grown rapidly in Colorado;

  By size, firms in all states with 1-9 employees lost workers on average, between 1972-77;

  Those with 10-99 employees gained 2.1 employees per firm, on average, between 1972-77;

  Slowest-growing small business sectors are mostly in older industrial states such as New York, Illinois, Michigan;

  Small firms with 10-99 employees in rapidly growing states added employees about twice as fast on average between 1972-77 compared to firms with under 10 employees.

  States on the East Coast adding employees most slowly include Connecticut, New York, and Rhode Island; and

  States in the West adding employees most quickly include Nevada, New Mexico, and Wyoming.

CHAPTER III. FINANCIAL DEVELOPMENTS AND THE SMALL BUSINESS SECTOR

Rising Inflation and High Interest Rates

- Expansionary monetary policy was the primary reason for the high inflation of the past 15 years. High interest rates are primarily caused by a rising rate of inflation.

- Rising inflation creates a false impression of business profits due to understatement of inventory costs, under-allocation of capital consumption allowances, and overstatement of the purchasing power of financial assets held by firms.

- Debt financing has increased because businesses attempt to maintain the rate of return on equity and to preserve the value of assets in an inflationary period.

- Increasing dependence on debt causes many small businesses to be vulnerable to the disruptive impact of high interest rates and declining sales.

The Economic Recovery Tax Act of 1981 (ERTA)

- The Administration's Economic Recovery Tax Act has been designed to provide long-term stable growth to the American economy, encouraging more savings and investment and providing greater incentives to work.

Small Business Difficulties During the Redirection of the Economy

- A deceleration in the growth of money supply during a period of continual inflationary expectation resulted in an exceptionally high real interest rate during 1981.

- Excessive cost of borrowing and reduced availability of funds in a slow economy caused great difficulties to the cash flow position of many small businesses. Heavy dependence on bank loans and short maturity of their debt structure increase the vulnerability of small businesses during this period.

- Business bankruptcies have increased substantially during 1981 and the small business concern over high interest rates is at an all-time high.

Major Developments in the Financial Industry

- Deregulation of the depository institutions has resulted in more competition in the financial services industry. Many small institutions will be acquired or will cease to exist as a result of increased competition. The effect on small business financing is uncertain at this time. However, the real cost of financing for businesses in many localities will likely rise because of the increased competition for deposits in a more integrated financing environment. The major issue facing very small business owners is whether they will be able to bid successfully for high cost funds.

- Variable rate loan arrangements allow banks to extend loans with longer maturity. However, small business will face greater uncertainty regarding the cost of financing under this arrangement.

- Budgetary deficits remain a major concern to many small businesses already experiencing difficulties in the credit market.

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CHAPTER IV. EFFECT OF FEDERAL POLICY ON SMALL BUSINESS

Impact of Federal Policy on the Availability of Credit and Equity Capital

Credit Environment

- Small banks (those with assets of less than $10 million) and medium-sized banks (assets of $100 million up to $1 billion) provide approximately 75 percent of the total dollar volume of bank credit to small business. Many small business owners are concerned whether their financing needs will be accommodated with the current restructuring of the financial services industry.

- Small financial institutions are likely to remain viable because they supply the financial needs of small business in local communities as well as provide the ancillary financial services demanded by private individuals and business owners at a reasonable cost.

- Federal credit assistance to small business over a 25-year period shows steady growth. Measured by total loans and guarantees outstanding since 1954, small business assistance rates second only to export assistance.

- Credit assistance to small business has not grown nearly as much as transportation and military credit assistance programs since the mid-1970's. The main SBA business lending program has for each of the past five years lent about the same amount of money with the same number of loans.

Equity Capital Environment

- Small firms face growing difficulty generating or retaining equity from both external and internal sources. Inflation increases the difficulty of raising funds in the equity markets because of the higher rate of return needed to replace assets valued at pre-inflation cost.

- The enactment of the Employee Retirement Income Security Act (ERISA) and the erosion in the real value of equity holdings have made it more difficult for small issuers to raise capital in the equity markets. The flight of individual investors from the traditional equity markets in the 1970's has diminished the depth and liquidity of the market for new issues and has increased the conservatism of the investment climate discouraging further a small issuer contemplating a public stock offering.

- The combined totals of Federal and State income tax liabilities and dividend payments have absorbed a larger percentage of adjusted pre-tax profits since the late

Sixties. In 1966, taxes and dividends represented 64.4 percent of the adjusted pre-tax profits. In 1977 this was 80 percent.

Impact of Securities Laws on Small Business

- While there are important public benefits from requiring accurate and standardized disclosure, small firms have experienced problems raising capital under the requirements of the Securities Act of 1933 because of the costs and contingent liabilities that accompany a full registration.

Impact of Federal Policy on Venture Capital Services

- The cost of venture capital increases with inflation. Therefore, the pressure for higher yields by the venture firms and the need for continuing financing of small companies and for new sources of venture capital are great.

- While remaining static from 1969-78 at $2.5 to $3.0 billion, the total venture capital pool expanded by nearly $800 million during the two-year period 1978-80 and by approximately $800 million more in 1980.

- The size of the venture capital pool in 1981 is estimated to be $5.0 billion. Of this sum, about one-third is currently in liquid assets and available for new investments.

- If venture capital is to provide an adequate source of financing for the small business sector, more emphasis must be placed not just on increasing the flow of venture capital to the small business sector, but also on the number of professionally managed venture funds.

Small Business and Tax Policy

- The Economic Recovery Tax Act of 1981 (ERTA) includes seven provisions that are specifically designated as small business provisions. The changes relate to 4 areas: corporate tax rates; accumulated earnings surtax; Subchapter S corporations; and inventory accounting. From a revenue standpoint the total cost of these is no more than $230 million in the peak year.

- Small businesses that operate as sole proprietorships, partnerships, or Subchapter S corporations will benefit since the income of these entities is taxed directly to the owners at individual income tax rates.

Impact of Federal Regulatory Policy on Small Business

Government-wide Regulatory Efforts

- A 1979 SBA study revealed that paperwork burdens alone cost small business $12.7 billion per year.

- A research study funded by the SBA demonstrated that regulatory costs are exponentially higher per unit sale for firms with fewer than 50 employees.

- In 1963 the small business share of the GNP was 43 percent. By 1976 that share had dropped to 39 percent. A major contributing factor is the overall regulatory burdens imposed on small business.

Employee Retirement Income Security Act

- ERISA was a major factor in the decision to terminate about 41 percent of small plans terminated in 1979. Common small business complaints are that the rules are too complex, compliance with the many paperwork requirements is burdensome, and delays in issuing rules, opinions, and exemptions make it difficult to understand what constraints exist on a specific pension plan.

Amendments to the Multiemployer Pension Plan Amendments

- Withdrawal liability has proved to be a major obstacle to small companies that want to sell assets, merge with another company or engage in various other common business transactions.

Davis-Bacon Act

- The major problem for small business under the Davis-Bacon Act stems from the regulatory process used to set "prevailing" wage rates for job categories. Often the resulting wage has been set above actual area wage rates.

- By tiering compliance burdens, small construction firms could be encouraged to compete for government projects at a substantial savings to the taxpayer while reducing the regulatory burden on the small business community.

Service Contract Act

- It is estimated that between $5 and $10 billion is spent annually on Federal service contracts, 75 percent of which is wages and fringe benefit costs.

- Small business' major complaint with these government contracts has been the mandated wage rates which decreased the participation of small firms in bidding for Federal contracts.

Occupational Safety and Health Administration

- Environmental and occupational safety and health rules alone reduce U.S. productivity growth by one-third of a percentage point annually.

- Chief among small business' complaints has been over-inspection policies of OSHA. In 1979, almost 30 percent of all inspections were in establishments with 10 or fewer workers (covering 17 percent of all workers) and nearly 50 percent of all inspections were of firms employing 25 workers or less (accounting for nearly 30 percent of all workers). Businesses with more than 26 employees represent more than 70 percent of all workers and are responsible for 72 percent of all fatalities. Recent developments demonstrate a reversal in this trend. Safety efforts are now concentrated on those businesses with a high incidence of injury.

Regulation of Government Procurement

- Federal procurement of goods and services is a $110-billion-a-year business involving one-fifth of the Federal budget, more than 130,000 Federal employees working in over 100 Federal agencies, and over 17 million procurement actions a year.

- Of contracts over $10,000, small business received $14.8 billion, or about 15 percent of large contract dollars. Of the total Federal procurement expenditure, small business received $25.4 billion, or 23 percent. While small business creates 38 percent of the GNP, it is generally concerned with what it perceives to be its low level of participation in the Federal procurement process. In recent years, the small business' market share of Federal procurement has been declining.

- A survey of nineteen agencies conducted in 1978 and in 1979 found that there are 485 offices regularly issuing procurement regulations, 877 different sets of regulations, and 64,600 pages of regulations in effect. Twenty-one thousand and nine hundred new or revised pages of procurement regulations are issued each year.

- Recent research by the Office of Advocacy indicates that large firms receive about $2 billion a year more than small firms in monies tied to Independent Research and Development/Bid and Proposal costs. These are not costs related to doing business as much as they are subsidies to certain companies in obtaining further Federal contracts.

- Despite the efforts of SBA and the various Offices of Small and Disadvantaged Business Utilization in contracting agencies, the average annual increase in percent of total Federal procurement awarded to small business between 1970 and 1978 was less than 1 percent.

- Many small business people with good performance records have discontinued business with the Federal government because of late payment problems. The General Accounting Office (GAO) has estimated the cost of these late payments to the private sector to be between $150 and $375 million.

Impact of Federal Policy on Innovation and Patents

- Only about 4 percent of the $40 billion the Federal government spends on Research and Development (R&D) goes to small business. In Fiscal Year 1980, the small business share of Federal R&D contract actions over $10,000 for major R&D agencies ranged from 7.6 percent for the Department of Energy to 2.3 percent for the National Aeronautics and Space Administration.

- In 1962, two years and $6 million (or $15 million in current dollars) were necessary to bring a new medicine from the laboratory to the consumer. It now takes an average of 7-10 years and about $70 million to complete this process. The delayed return on investment results in a concentration of innovation in larger firms which are better able to underwrite the full costs associated with new products.

The Role of the Federal Government on International Trade

- Eight and three-tenths percent of the Nation's 300,000 manufacturers export regularly and less than 1 percent account for 84 percent of U.S. exports. Small businesses, while representing 38 percent of the GNP, produce only 16 percent of the export sales.

  It has been estimated that each $1 billion of exports produces 40,000 new jobs. Small business accounts for some 86 percent of all new employment in the private sector. Increased participation in exporting by small business translates directly to increased domestic employment opportunities.

Senator D'AMATO. I am particularly gratified to hear your last remark, Frank. In terms of the special programs, you say that they have little impact on the small business community. I agree with you; I think that is patchwork. The main emphasis, if we are going to turn things around, is to make it possible for the cost of doing business to come down appreciably.

We recognize that a major part of that cost is the inordinately high interest rates that the small businessperson has to pay. Often that makes it impossible for him or her to obtain any line of credit. It makes it impossible for him or her to go out and purchase sufficient inventory. It makes it impossible for him or her to conduct normal operations.

It is not unusual to find today a number of rather successful individual entrepreneurs, who had run very successful small businesses, providing services and goods and making specialty items in many cases, whether it be in machine tools, whether it be in fabrics or a whole variety of things, who are going out of business. They are closing their doors. They cannot get adequate capital to continue, capital that heretofore had been rather easy to obtain on a regular basis.

They are businesses who have had a sound track record. We are not talking about someone who comes in as a speculator with a good idea, who wants to make a fortune with someone else's money. We are not talking about the high-cost-inventory kind either; we know that they have an acute problem. We are talking about people who have heretofore done very well. This cuts off the consumer from this option, as well as creating an economic dislocation for that entrepreneur and his or her employees and for the suppliers that he or she once had.

I am very much concerned, and I agree with your basic outline.

Let me ask you this question. It may be perceived to be somewhat inconsistent, but I do not think that is the case. I think industrial revenue bonds, particularly as they relate to small businesses, have been rather effective. Last summer, the IRS, in Ruling 81-216, killed the State umbrella bond program whereby small businesses could pool their small issue bonds. I am asking whether or not you have had an opportunity to analyze the administration's legislative proposals for modifying the small issue tax exempt IDB program?

Mr. SWAIN. We analyzed closely the administration's regulatory proposals and agree that IDB has been a very important technique to the smaller firm that might not have other sources of capital. We submitted a lengthy comment to the IRS in December suggesting that such a basic change in IDB practice was something that ought to be debated in the Congress and not changed by regulation. We are in the process of analyzing the administration's current proposals. I really do not have a final statement now, except that I would strongly urge the administration to bear in mind that whatever problems there are with the IDB, they should not kill the part of it that is of genuine help for small business. Maybe there ought to be some cap or further guidelines on proper types of investments. Admittedly, if you are going to deprive the Treasury of revenues through a tax-exempt item, it ought to be done carefully and properly to make certain you are getting the best effect. They

should not go ahead with their bundling proposal that they went ahead with in August, which would really eliminate small business access and not do much to overcome some of the other abuses that were named.

Senator D'AMATO. Frank, where does the SBA's small business data base stand? How are we doing on that?

Mr. SWAIN. I think in this report we have the first major outputs from the data base. It is a complex project to try to track all the businesses in the country and where they are winning and where they are losing, but I can see some genuine progress. This program is fully documented in appendix B of "The State of Small Business." The President's message said on page 11 "I am directing the Commissioner of the Internal Revenue Service to include representatives of small business in advisory groups which review administration of the tax system." We also plan to publish a compendium of new information from the data base before the end of this summer. I think the Congress has been very confident in the SBA's ability to put together a data base for a couple of years now, and we have to start producing for you. I fully intend to make that happen by the end of the summer.

Senator D'AMATO. What is the status of the Small Business Advisory Council at the Department of the Treasury?

Mr. SWAIN. I am tempted to say that your guess is as good as mine.

Senator D'AMATO. That is OK.

Mr. SWAIN. I will find out. I do not think there is one now, and we have been trying to urge them to get one.

Senator D'AMATO. I was going to say, Will there be one?

Mr. SWAIN. I am not sure. The President indirectly stated that there would be members of the small business community put on his advisory council at Treasury, but not that there would be a small business advisory council.

Senator D'AMATO. Let me say this for the record. I have been heartened by your enthusiasm, the creativity that you have demonstrated, and also your outspoken advocacy on behalf of small business. I think you demonstrated that when you took the position that you did and wrote to Treasury with respect to the industrial revenue bonds, as they related to small business. That demonstrated to me a concern for the issues. We do not hold it as the panacea, but certainly during these difficult economic times I think you came down on the right side and certainly gave this Senator every reason to believe that your choice as counsel for advocacy was an excellent one.

I commend you and hope you continue in that manner, which is an effective manner, and in the long run is going to create great stability for this administration. If people continue to close their eyes to the economic difficulties we face and do not attempt within their ability to modify policies and positions and to be thoughtful spokespersons and workers for change when they see it is necessary, we are going to have a great deal of difficulty. So I commend you for what I have perceived to be an excellent job, and I know that the word is getting out throughout the small business community that you are indeed an excellent advocate and counsel for their interests.

Mr. SWAIN. Thank you very much, Senator. You are very kind.

Senator D'AMATO. This committee stands in recess.

[Whereupon, at 11:37 a.m., the committee recessed, to reconvene at the call of the Chair.]

[Subsequent information was received and follows:]

U.S. SENATE,
COMMITTEE ON SMALL BUSINESS,
Washington, D.C., April 2, 1982.

Hon. FRANK S. SWAIN,
Chief Counsel for Advocacy,
Small Business Administration,
Washington, D.C.

DEAR MR. SWAIN: In follow-up to the Senate Small Business Committee's March 31, 1982 hearing concerning the President's first Annual Report to the Congress on "Small Business and Competition," I would appreciate it if you would provide responses to the attached questions for the hearing record.

Thank you for your timely consideration.

Sincerely,

LOWELL WEICHER, JR.,
Chairman.

Enclosures

MR. SWAIN'S QUESTIONS

Question. The number of bankruptcies and business failures show a dramatic increase. The data in the report (particularly on the shrinking size of the small business establishment) seems to indicate that this trend is continuing, and may be accelerating.

What do you see as the urgency of addressing the deficit and interest rate questions for small business?

Answer. I believe that my testimony focuses on this question. As I stated in my written testimony, I believe it is critical for the welfare of the economy that the financial markets including both the credit markets, the equity markets, and the bond markets come to a relatively stable position. I believe that the expectation of the actors in these markets with respect to the potential large size of the deficit deter the markets from stabilizing at price levels which are reasonable for the long term growth of the American economy. I do not believe that expectations will stabilize until the financial community and the business community come to terms with the size of the anticipated Federal deficit for fiscal year 1983 and fiscal year 1984. In my testimony, I indicated that it was my belief, based on my interactions with members of the small business community, that the deficit must be lowered. I believe that the small business community would suppport a program emphasizing continued cuts in Federal spending, in both discretionary and entitlement programs.

Question. What is the recommended budget for the Office of Advocacy for Fiscal Year 1983? How does that compare to the budgets for the Office of the past three fiscal years? How many employees are presently assigned to the Office of Advocacy?

Answer. The recommended budget for the Office of Advocacy for Fiscal Year 1983 is $5,652,000. Budget totals for the past three years, adjusted to include expenditures for the Office of Women's Business Enterprise are; 1980—$7,249,000, 1981—$7,274,000 1982—$7,963,000. There are presently 86 employees assigned to the Office of Advocacy. Of these, 81 employees work on a full-time basis and five student aids work on a part-time basis.

Question. What is the status of the small business data base, including the "indicative" data base? When can the Senate Committee on Small Business expect to start receiving from SBA small business economic data on a regular basis, for instance, monthly?

Answer. The status of the small business data base is fully described in Appendix B of the Report on the State of Small Business. The Appendix focuses primarily on the external data base and outlines the capability of the SBA data base when compared to other data sources in the Federal Government. The Appendix does not cover the indicative data base.

The indicative data base is a name and address listing of small businesses in the U.S. Economy. Name and addresses from the Dunn and Bradstreet Market Identifier Files are being matched with name and address listings from Market Data Retrieval Inc., to produce a more comprehensive listing of the firms in the economy.

The matching process involves a complicated algorithm which basically compares each element of information in the name and address listing to determine whether or not the entry on one file duplicates the entry on the other file. Data files are being matched by state, beginning with the smaller states, and we expect the total matching process to be completed by July, 1982. At that time we believe that the indicative data base will contain approximately seven million entries. I want to be able to give monthly reports to this committee as well as other interested groups before the end of 1982.

Small Business Advisory Council at Treasury

Question. What is the status of a Small Business Advisory Council at the Department of Treasury? Will there be one or not?

Answer. A Small Business Advisory Council does not now exist at the Department of Treasury. I know of no plans to create such a Council.

Section 385 Debt Equity Regulations

Question. The IRS has issued another set of regulations under Internal Revenue Code Section 385. These regulations attempt to define debt and equity for tax purposes.

What Congress is hearing from the small business community is that these regulations, all 30 pages or so, are nothing but an incomprehensible mess and that the lawyers and accountants cannot even figure them out—much less the average small businessman.

What is your opinion on these regulations? Are they consistent with the congressional small business objectives set out in Public Law 96-302? Should the Congress just repeal Section 385 and thereby do away with Treasury's rule making authority in this area?

Answer. The debt/equity rules recently proposed by the Internal Revenue Service [IRS] are so complicated that without major changes they will only exacerbate the problems experienced by small business people. On March 8, 1982, the Office of Advocacy commented on the proposed rules to the IRS. A copy of those comments are enclosed.

I think the rule as drafted is too complicated and should be significantly changed or withdrawn. By establishing safe harbors and clearer tests the rule could benefit the small business community if it were drawn simply enough. The proposed rule requires more work. If IRS refuses to make significant modifications, revocation of section 385 may be the best answer for small business.

Antitrust No. 1

Question. In his recent message to Congress on the state of small business, President Reagan has stated that "small businesses rely upon the free functioning of markets to compete and prosper." (President's Report at 15) The President went on to state that "The Attorney General will vigorously prosecute anti-competitive behavior." (Report 16) The May 7, 1981, Wall Street Journal quoted William Baxter, the administration's chief antitrust enforcement official as saying that he views "large companies as very valuable things . . . partly because they perform some tasks more efficiently than smaller ones." The July 8, 1981, Wall Street Journal repeated that quote and added Baxter's words that large firms "tend to be the most efficient."

Assuming for the moment that the Administration will be able to limit its antitrust enforcement activities to situations where efficient companies have been the victims of antitrust violations, what do you think antitrust enforcement policy should be when the government is presented with an antitrust claim by a small company concerning its large competitor if that large competitor can justify its conduct on the basis of economic efficiency? Stated another way, in our view, should the President's promise to "vigorously prosecute anti-competitive behavior" be tempered by demonstrations of greater efficiency of large enterprises, as Mr. Baxter has suggested?

Answer. The antitrust laws are intended to promote economic efficiency by fostering competitive markets. While it is possible that it would be more efficient to have one steel company or one automobile company, the antitrust laws are premised on the correct perception that the best way to promote that efficiency is by assuring that competition exists in the markets served by those firms.

There is substantial evidence that small firms, in many industries, can be as efficient as large. Of course economies of scale differ among industries. However when

economies of scale are artificial due to regulatory or tax provisions which favor largeness or when greater "efficiency" is maintained by unfair or collusive practices, I do not believe claims of "efficiency" should be given much weight.

In fact there is no "efficiency" defense to an antitrust claim. Government cannot regulate markets into efficiency, either through traditional command and control regulation or through antitrust enforcement. Thus I believe the focus of governmental attention in looking at large firm behavior or mergers should be the impact of the action on the ability of other firms to compete and on the elimination of competitive opportunities for small firms in relevant markets. If government protects competition, competition will ensure efficiency.

ANTITRUST No. 2

Question. In an interview reported in the August 3, 1981, U.S. News & World Report, Mr. Baxter was asked the following question: "Do small firms have anything to fear from this Administration's enforcement of the antitrust laws?" Mr. Baxter's answer was as follows: "To the extent we succeed in enhancing the efficiency of some industries by administering a more coherent, economically based, efficiency-oriented version of antitrust, price levels will fall, and some small enterprises will probably be squeezed out of those markets." What would you do for the efficient small enterprises that are squeezed out of the market as a result of Mr. Baxter's new antitrust philosophy?

Answer. Efficient firms will always squeeze less efficient firms out of competitive markets. It is wrong to assume that small firms are necessarily the inefficient members of a market. If small, inefficient firms are squeezed out of competitive markets by large or small firms producing a better product or service at a lower price I would not be concerned. The foundation of our free enterprise system rests on continued opportunity for small firms to innovate, expand markets and provide greater consumer satisfaction. This opportunity to succeed must carry with it the opportunity to fail.

I am concerned when small firms are driven out of business by disporportinate regulatory or tax requirements that create artificial benefits to being big. My job is to take part in the process of removing these barriers to small firm opportunity that are currently fixed in law and regulation.

ANTITRUST No. 3

Question. Do you agree with the views expressed by the Supreme Court in the *Brown Shoe* case as follows: "It is competition, not competitors which the act protects. But we cannot fail to recognize Congress's desire to promote competition through the protection of viable, small, locally owned businesses. Congress appreciated that occasional higher costs and prices might result from the maintenance of fragmented industries and markets." If you accept this language of the Supreme Court concerning Congress' motivation in passing the Sherman Act, do you believe they square with Mr. Baxter's views?

Answer. The *Brown Shoe* decision and others recognize that protection of competition necessarily involves maintenance of fragmented and diverse markets. In *Brown Shoe* the court recognized protection of small firms as an important antitrust factor, but not the primary goal of the law. "Taken as a whole, the legislative history illuminates congressional concern with the protection of competition, not competitors, and its desire to restrain mergers only to the extent such combinations may tend to lessen competition." 370 U.S. 294, 320 (1961).

The language of the Supreme Court in *Brown Shoe* acknowledges that protection of competition is not the same as protection of competitors. Where there is a clear conflict between the two, I would, as a general rule, agree with the Court in favoring protection of competition rather than competitors. To do otherwise would be to permit erection of entry barriers to the new, small firms that are the sparks of competition.

ANTITRUST No. 4

Question. In the SBA's Annual Report on Small Business and Competition it is stated that many observers "increasingly have come to recognize, in some instances the vertical restrictions can have beneficial effects." (Report at 175.) This comment is extended by noting that the Supreme Court has held with respect to intrabrand restraints that restraints other than resale price maintenance "should be judged permissible elements of a marketing system unless clearly shown to have an anticompetitive effect." The Report then cites the *G.T.E. Sylvania* decision in support

thereof. (Report at 176.) Will you submit for the record the language in *G.T.E. Sylvania* which says that nonprice vertical restraints "should be judged permissible" unless "clearly" anti-competitive.

Answer. I do not believe that a "presumption" of reasonableness ought to exist in the antitrust laws for vertical restraints. There may be situations where vertical restraints promote legitimate economic concerns of manufacturers. However, when vertical restraints limit the ability of downstream market participants to utilize the competitive tools available to them, I believe the antitrust laws require the court to question the facts of the particular competitive situation. The rule of reason does this—by applying the language of section 1 of the Sherman Act through a weighing of the circumstances of a particular case to decide whether the challenged practice promotes or suppresses competition.

The following holding of *Continental TV* v. *G.T.E. Sylvania* at 433 U.S. 36 supports this statement:

"We revert to the standard articulated in *Northern Pac. R. Co.,* and reiterated in *White Motor* for determining whether vertical restrictions must be 'conclusively presumed to be unreasonable and therefore illegal without elaborate inquiry as to the precise harm they have caused or the business excuse for their use.' 356 U.S. at 5. Such restrictions, in varying forms, are widely used in our free maket economy. As indicated above, there is substantial scholarly and judicial authority supporting their economic utility. There is relatively little authority to the contrary. Certainly, tnere has been no showing in this case, either generally or with respect to Sylvania's agreements, that vertical restrictions have or are likely to have a 'pernicious effect on competition or redeeming virture.' Ibid. redeeming virtue." Ibid. Accordingly, we conclude that the per se rule stated in *Schwinn* must be overruled. In so holding we do not foreclose the possibility that particular applications of vertical restrictions might justify per se prohibition under *Northern Pac. R. Co.* But we do make clear that departure for the rule-of-reason standard must be based upon demonstrable economic effect rather than—as in *Schwinn*—upon formalistic line drawing.

In sum, we conclude that the appropriate decision is to return to the rule of reason that governed vertical restrictions prior to *Schwinn.* When anticompetitive effects are shown to result from particular vertical restrictions they can be adequately policed under the rule of reason, the standard traditionally applied for the majority of anticompetitive practices challenged under section 1 of the act.

ANTITRUST NO. 5

Question. Referring again to the same portion of the Report on Small Business, at 176, is it correct to say that resale price maintenance would be viewed as illegal under the Sherman Act? If so, do you agree with Assistant Attorney General Baxter's comment, as quoted in the Wall Street Journal of May 7, 1981, that in many circumstances practices such as resale price maintenence "are the most efficient ways of doing business" and that "legal precedents against those efficient arrangements harm consumers by driving up costs and prices"?

Answer. It is difficult for me to see how a ban on resale price maintenance harms consumers or drives up prices. What resale price maintenance does do is limit the ability of independent sellers to use competitive tools available to them—price and service. I am not aware that any court has significantly changed the law regarding resale price maintenance that, in general, it is illegal.

ANTITRUST NO. 6

Question. The SBA Report seems to argue that for some small manufacturing enterprises, nonprice vertical restraints would be helpful just as they are helpful to the small manufacturer's large competitors. Do you think the same policy should apply to small business enterprises that do not engage in manufacturing but rather provide services or distribute products? Do you have any on the breakdown of small business enterprises among manufacturers categories? If so, do you have an opinion on the relative value to the small business community of advocating a more liberal vertical restraint policy than is allowed by the present law? Stated another way, overall in your opinion would small business benefit by liberalizing the antitrust rules with respect to vertical relationship?

If you have not done such a study, do you think that one should be commissioned so that Congress and the administration will be able to know what the impact of current antitrust policy on vertical relationships is on small business?

Answer. Vertical restraints imposed to assure product quality or provision of needed ancillary services benefits small manufacturers as well as large. Vertical re-

straints imposed to limit competitive opportunity of individual wholesalers or retailers hurt small business in the long run. While firms protected from competition might benefit initially from such territorial or product protection, I believe that unlimited opportunity to grow or fail serves small business better. Thus, small manufacturers or service providers who seek to impose vertical restraints should be subject to the same legal limitations on vertical restraints as larger firms. Of course if small firms in a particular situation enjoy minimal market power, the application of the rule of reason to the restraint in question may produce a different result from the situation where the same restraint is applied by a larger firm where the effect on competition or commerce may be greater.

Charts on page 186 and 205 of the report, among others, break down the manufacturing and nonmanufacturing shares of small business in the economy. However, it will be difficult to measure, without detailed studies market-by-market, whether a more liberal vertical restaint policy would be beneficial overall to small business. It a study where to be done I would suggest that a more detailed industry specific study be conducted in order to measure individual firm behavior in response to vertical restraints rather than to attempt to measure economy-wide response.

ANTITRUST No. 7

Question. The SBA's Report states that "vigorous" enforcement of the Robinson-Patman Act is a general concern of small business. The Report then cites Professor Scherer's comment that small business has borne the brunt of the FTC's Robinson-Patman Act enforcement effort. (Report at 176–77.) Isn't it true that while Professor Scherer may be right, his quote does not support the Report's conclusion based on the Professor's statement that "there is little evidence that the act's enforcement generally has benefited small business?" Is the report, in effect, advocating a decrease in Robinson-Patman enforcement actions?

Answer. The report does not advocate a decrease in Robinson-Patman Act enforcement. It is clear that the Robinson-Patman Act has been used more by private plaintiffs than by the Government.

Of the 18 Robinson-Patman Act cases reported in 1980, only two resulted in a decision for the plaintiff. Data does not exist on the number of cases settled or dropped. Thus it is difficult to measure the true impact of the act. The Robinson-Patman Act may play an unmeasured but important role in large firm pricing behavior, as firms seek to avoid court action altogether.

ANTITRUST No. 8

Question. Concerning Robinson-Patman, the SBA Annual Report does seem to state that price discrimination should be prevented by use of the Robinson-Patman Act. (Report at 177.) How do you square this comment with the comments of Assistant Attorney General Baxter that the Robinson-Patman Act is a "dreadful piece of legislation?" (Dunn's Review, August 1981). That it is full of "absurdities" (American Lawyer, July 1981), and that it is an "unjustified protection for small business from the rigors of competition" (New York Times, April 26, 1981).

Answer. The Robinson-Patman Act has produced a complicated string of rules, defenses and requirements for firms seeking to utilize the act or for those seeking to avoid transgressing it. Because the deterrent effect of the Robonson-Patman Act is unknown but conceivably significant I would be reluctant to weaken the Act simply because it is not often used. Many of the pricing schemes currently attacked under the Robinson-Patman Act might also be reachable under section 2 of the Sherman Act.

ANTITRUST No. 9

Question. In cases of predatory practices of large firms against smaller firms involving price, do you believe that use of the Robinson-Patman Act should abandoned in favor of using section 2 of the Sherman Act?

Answer. Since the full impact of the Robinson-Patman Act as a deterrent is unknown and I have not conducted a survey of which Robinson-Patman Act cases could also have been brought under section 2 of the Sherman Act I would not abandon the Robinson-Patman Act. Given the trend in court decisions relating to Robinson-Patman, as an attorney for a plaintiff which was the victim of discriminatory pricing, I would certainly attempt to include claims in addition to Robinson-Patman in my complaint. Predatory pricing is not an easy claim to prove, either under the Robinson-Patman Act or the Sherman Act. The evidence is always complex and the

courts have not had an easy time developing consistent standards of acceptable proof for predatory pricing causes of action.

ANTITRUST No. 10

Question. Some small business groups such as the Small Business Legislative Council, have criticized the antitrust enforcement philosophy of Assistant Attorney General Baxter and Federal Trade Commission Chairman Miller, especially as that philosophy applies to the Robinson-Patman Act. If a consensus should develop among the small business community that the Administration's present antitrust philosophy does not serve the interests of viable and vigorously competitive small businesses, do you believe the Chief Counsel for Advocacy should step in to fill the antitrust enforcement gap?

Answer. I do not believe that the Chief Counsel for Advocacy should have separate antitrust enforcement authority, just as the Chief Counsel should not have separate authority to enforce any other law applicable to small business. As a policy advocate, the Chief Counsel should direct his resources to performing that function well. Should the Congress develop a concern as to the enforcement policies of the Justice Department or the Federal Trade Commission, then the Congress should instruct those agencies to change their policies.

FEDERAL REGULATIONS

Question. One of the major cornerstones of the President's economic program is the elimination of burdensome Federal regulations. SBA's Office of Advocacy has a significant role in determining the effects of Federal laws, regulation and activity on small businesses. The current budget proposal asks on page 69 for a reduction of $2.3 million and 12 positions in the Office of Advocacy. What is the anticipated program impact on the office's role in regulatory oversight?

Answer. We anticipate that the Office of Advocacy will be able to carry out an effective regulatory oversite program during fiscal year 1983, even though budget and staff for the office have been reduced. It should be noted that a major portion of the dollar reduction is related to Advocacy activities other than the regulatory oversight program and may not have a great effect on our ability to carry out such oversight.

Statistics taken from the Federal Register show the pattern of growth in the number of proposed rules and the number of final rules published in the Federal Register from 1978 through 1982. The numbers indicate that the number of final rules proposed has fallen 25.5 percent from the first 3 months of 1979 through the first 3 months of 1982. The number of proposed rules has fallen even more significantly, declining by more than 50 percent during the same time period.

A continuation of these trends is expected through 1983 and we expect that we will have more staff time available per rule reviewed in 1983 than we do now. Thus, we anticipate that we will continue to have effective oversight over both proposed and final regulations as published in the Federal Register. It should be noted that we are also, as a management practice, systematically identifying classes of rules which have little or no burdensome effect on small business. If these classes of rules are identified, we can remove them from intensive oversight activity and concentrate more intensively on burdensome rules.

The key issue of regulatory oversight for 1983 and future years is review of rules which are already on the books. This is called for by Executive Order 12291, the Regulatory Flexibility Act and pending regulatory reform legislation (S. 1080 and H.R. 746). The Office of Advocacy must be able to play an effective role in prodding the agencies into this review.

As you know, the primary responsibility for compliance with the Regulatory Flexibility Act rests with the agencies themselves. We have spent considerable amounts of staff time working with officials at the agencies and expect to distribute guidelines in the near future for making the determinations and analyses required by the act. As the agencies, and for that matter my office, understand the act's requirements more fully, we should be able to more effectively comply.

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